

ber banks are not doing the same thing. While opinions differ on this point, it is probable that the member bank could lend at least \$1500 in demand deposits to business men on the strength of an increase of \$1000 in its legal reserves. This is possible because loans in the form of demand deposits are not always entirely checked out by the borrowers and, when checks are drawn against such deposits, they are often redeposited in the same bank. Thus, a bank, by obtaining \$1000 through rediscounting at 5 per cent, is enabled to lend, say, \$1500 to business men at 6 per cent. And even if the rediscount rate is raised, the bank may continue to lend extensively and profitably to its customers without charging them more than the former rate of interest, namely, 6 per cent.

Of course, when a member bank obtains an additional reserve of \$1000 in this way, it has the *legal* right to increase the demand deposits of its customers, by lending (by any amount up to \$10,000, on the average) on the basis of the small legal reserve normally required against demand deposits. This right, however, cannot be exercised by one bank alone. If a single bank expanded its deposits in this way, the enlarged deposits would cause a very large number of checks to be drawn against the bank by its depositors. The clearing house claims against this bank would then be much larger than the bank's claims against the other banks in the clearing house. These daily net adverse balances would eventually drain away much of the bank's working cash, and force it to reduce its deposits. However, when all or most member banks are rediscounting and expanding credit, a given bank may reach something approaching the maximum legal average expansibility of ten times the amount of reserve added by rediscounting; for under these circumstances the checks drawn by its customers against demand deposits are largely offset by the checks it receives which are drawn on other member banks. If this is the situation, even a 5 per cent rise in the rediscount rate would mean a rise of only one-half of one per cent, or a little more, in the interest rate charged to business men. In practice, the member banks might not raise their interest rates at all.

Even if this policy of the Federal Reserve control succeeded in raising the rates which member banks charged business men, the rise might not check borrowing greatly. When a business man expects to make a profit of 10 or 20 per cent by using borrowed funds, he is unlikely to be restrained by the necessity of having to pay, say, an additional one per cent for these funds. Finally, it is entirely possible that our domestic policy of control might be upset by concerns in foreign countries, should they decide to take advantage of the high interest rate by making us extensive loans. And even domestic corporations with idle funds might throw them into the market if the interest rate obtainable were very high.

Ineffective as changes in rediscount rates have been in preventing the overexpansion of credit, they have been even less successful in checking

ECONOMICS:

Principles and Problems

REVISED EDITION

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play, because a part of these reserves was commonly deposited at interest with other banks and might not be available in time of need.

One of the purposes of the Federal Reserve Act, as originally passed, was to alter these conditions so as to provide safety for the depositors of member banks. Though the actual percentages of reserves required against deposits were reduced, every member bank was compelled to keep these reserves in the Federal Reserve bank of its district, without interest. Then, in case of emergency, the Reserve bank could place at the disposal of the distressed bank not only its own reserve in the form of cash, but additional funds from the great pool of reserves which it held for the other member banks of the district. In this way, it was thought, no member bank would have to close its doors from inability to obtain funds. If there were runs on many member banks of a single Reserve district at one time, funds could be shifted from one district to another.

Bank Failures in Recent Years.—Many people, firmly convinced that banks could not fail under the Federal Reserve System, were greatly shocked and highly indignant at the large number of bank failures that took place even in good business years, and the almost total collapse of the banking system and unprecedented toll of failures that marked the depression years of 1929–33. In the prosperous period from 1921 to 1929, inclusive, 995 member banks failed, while 4719 non-member banks met a similar fate. During the four depression years, 1930–33, when member and non-member banks were given a severe test, 2110 member banks and 6796 non-member banks failed.¹ Let us examine these depression figures more closely. In 1929 there were roughly twice as many non-member as member banks. If member and non-member banks had been equally safe (or equally unsafe), we should have expected the ratio of failures between non-member and member banks to be two to one. Actually the ratio was greater than three to one. This comparison indicates that member banks provided a substantially higher degree of safety for depositors than non-member banks in these depression years.

In 1933, a bank holiday was declared, and all banks in the country were closed. After a few days, the banks which seemed to be sound were licensed to reopen, while the others were required to put themselves in satisfactory condition or eventually be liquidated. Since the beginning of 1934, there have been relatively few bank failures. From 1934 to 1940, inclusive, only 22 member banks and 291 non-member banks were closed on account of financial difficulties.²

The failure of non-member banks should not, of course, be charged against the Federal Reserve System. Non-member banks make loans on types of securities, for lengths of time, and for amounts that would not be permitted under the Reserve System, and they persist in following

¹ *Statistical Abstract of the United States*, 1939, p. 263.

² *Federal Reserve Bulletin*, March, 1941, p. 228.

ECONOMICS: PRINCIPLES AND PROBLEMS, REVISED EDITION

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many times in one year as in another, over long periods of time. Though they admit that the total volume of trade changes somewhat from time to time, they argue that fluctuations in T would not account for the great changes in price levels that have sometimes taken place. As for M and M' (money and credit), there can be no doubt that these items have fluctuated very greatly at times. The fact that their increases and decreases coincide rather closely with increases and decreases, respectively, in price levels, seems to indicate that the quantity theorists may have some justification for believing that money and credit are by all odds the most significant factors in bringing about these fluctuations in general prices.

Historical Verification of the Quantity Theory.—An examination of conditions that existed between 1913 and 1920, a period during which general prices in the United States almost doubled, tends to corroborate the theory that money and credit are the most important influences in effecting changes in price levels. Table 40 shows that the general price index rose from 58 in 1913 to 113 in 1920. If the total volume of trade had been smaller in 1920 than in 1913, part, at least, of this increase in general prices might be attributable to T . But, as a matter of fact, production and exchange actually increased in the period under discussion. Almost nothing can be said with assurance about V and V' during these seven years, but it seems probable that they are not responsible to any appreciable extent for the tremendous increase in general prices.

When we examine M and M' , however, we discover increases in the quantities of these factors which suggest very strongly that the high price level of 1920 may properly be charged up to them. The concrete facts about money and credit in the period under discussion are these: In 1913 the total amount of money in the United States was less than \$4,000,000,000, but by 1920 it was more than \$8,000,000,000. The amount of *increase*, to be exact, was 116 per cent. This increase was due largely to shipments of gold from Europe to the United States. Credit in form of bank deposits experienced an increase of 152 per cent from 1913 to 1920, jumping from less than \$9,000,000,000 to approximately \$22,000,000,000. Another increase in M' resulted from an extension of credit due to the rediscounting of commercial paper, and to a large volume of loans made on government bonds by the Federal Reserve banks. Finally, some \$16,000,000,000 worth of war bonds had been issued up to 1920, and these in many cases circulated just as freely as money, thus increasing greatly the total quantity of circulating media.

With these facts before us, it is not difficult to believe that M and M' were largely responsible for the extremely high price level of 1920, as compared with the level of 1913. Another evidence of the influence of M and M' upon price levels is to be found in the gradual increase in

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¹ This chapter is published in pamphlet form to facilitate making the frequent revisions required to keep this rapidly changing material up to date.

INTERNATIONAL TRADE: FACTS AND PRINCIPLES

IN DESCRIBING the process of exchange,¹ we looked briefly into the nature of trade and found that, in the final analysis, it consists of an exchange of commodities and services for other commodities and services. Indeed, the true nature of trade is most easily seen in its simplest form, barter; and it is for this reason that the student of economics is urged in specific cases to disregard temporarily the money phenomena of modern exchange and concentrate upon what is often much more significant, namely, the goods phenomena.

Barter, the Essence of All Trade.—In one phase of international trade—the phase that deals with making payment for goods imported and receiving payment for goods exported—the question of money is of considerable importance. But in international as in domestic trade, there is much to be gained in most instances by reducing the problem to its simplest terms. If, then, one thinks of trade, whether domestic or foreign, in terms of barter, there is small probability of being led astray by the intricacies of exchange as they appear in our highly complicated economic order.

Similarity of Domestic and Foreign Trade.—Our study of trade within a single country has prepared us for an excursion into the field of international business transactions. For, although domestic and foreign trade are not precisely alike, their differences are less pronounced than their similarities. All trade, it will be recalled, is closely related to specialization, and consists of certain persons exchanging surpluses of economic goods for the surplus economic goods of others.

Moreover, in foreign as in domestic trade, the transaction (with few exceptions²) takes place between *individuals*, and not between political units *as such*. When Pennsylvania steel is sold in Florida and Florida oranges are sold in Pennsylvania, the trade is conducted between individuals or business houses within the two states, and not between the states themselves. In like manner, it is ordinarily the individual business men of Europe and South America, and not the governments themselves,

¹ In chap. 31.

² As, for example, when the government of the United States provides the government of Great Britain with war supplies.

5. Show, with an illustration, how several international business transactions might be "settled" without the shipment of gold, and also without the assistance of dealers in foreign exchange.
6. What are the difficulties involved in a settlement of this kind?
7. Introduce dealers in foreign exchange into the illustration used in your answer to Question 6, and trace the operations that must be gone through before the settlement is completed.
8. How do dealers in foreign exchange build up "foreign balances," and how are these balances reduced from time to time?
9. Why is it sometimes desirable to employ "triangular exchange"?
10. Follow, step by step, the transactions outlined in Fig. 55. Is this process, in basic principle, different from that shown graphically in Fig. 54?
11. Indicate the manner in which the use of foreign exchange enables a creditor to receive payment in the money of his own country.
12. Define "parity of exchange."
13. Under what conditions will foreign exchange sell "above par"? "Below par"? Are your answers consistent with the statement that the problem of exchange rates "is one of supply and demand"?
14. What are "gold shipping points"? Why do rates of foreign exchange tend to remain within these limits?
15. Explain the meaning of "purchasing-power parity."
16. Under what conditions is parity of exchange based on purchasing power instead of on the gold content of money?
17. What is a "favorable" trade balance? An "unfavorable" trade balance?
18. Is a favorable trade balance necessarily desirable, and an unfavorable trade balance undesirable?
19. Does the statement that "there is a tendency for exports to equal imports" relate to merchandise alone, or to other items as well?
20. How do you explain the fact that foreigners sometimes buy goods in the United States, when similar goods are made and sold in their own countries?
21. Why would it be undesirable for a country to attempt to maintain a "favorable" trade balance indefinitely?
22. What have price levels to do with the maintenance of trade balances?

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and so long-continued that the lending country's credit base is reduced and the quantities of money and deposit currency in use are curtailed, there tends to be a decline in the general price level. On the other hand, the price level in the borrowing country tends to rise under the influence of the increases in money and deposit currency that have resulted from the borrowing process. In so far as the fall in prices in the lending country makes its goods appear cheap to other countries, it becomes a good place in which to buy and its exports become large in relation to its imports, since the commodities of other countries seem expensive as compared with the goods obtainable at low prices at home. On the other hand, the borrowing country, with its high prices, becomes a highly desirable market, while it is able to sell only comparatively small quantities of its commodities and services in other countries. As a result of this situation, the borrowing country comes to have an "unfavorable" balance of trade, while the lending country has an export surplus.

However, it is known that even substantial transfers of gold between countries do not necessarily alter their respective price levels. But whether the price levels change or not, the results may be much the same, for there is likely to be, in any case, an expansion of purchasing power in the borrowing country. The expansion may be extensive, since the country's banking reserves are increased by the inflow of gold, or by the acquisition of foreign exchange which is counted as reserves in some countries. The increase in the monetary demand for economic goods in the borrowing country is likely to stimulate production (and speculation), but a part of the purchasing power is likely to be used for importing products from other countries. Moreover, some part at least is likely to have the effect of increasing the exports of the lending country, either directly, or indirectly by way of another country or countries.

Qualifications and Conclusions.—This description of the effects of a persistent net outflow of capital from a particular country has been presented as simply as possible. Page after page of qualifications have been written on the theory described here. These qualifications concern such questions as the differences between domestic, import, and export prices when the general price level is rising or falling, the effects of lending upon countries not directly involved, and the influence upon trade relationships of such economic phenomena as dumping, international cartels, and tariffs and other obstacles to trade. The conclusion to be drawn from the discussion is that, when a country is experiencing a persistent net outflow of capital, its exports of commodities, services, and gold tend to be large as compared with its imports, while the reverse is true of the borrowing country. This import-export relationship in the lending country may come about through an increase in exports while imports are unchanged, by a decrease in imports while exports remain constant, or by a change in both. The same is true of the borrowing countries.

unit, the most nearly self-sufficient political entity in the world. However, for certain purposes, the empire cannot be considered as a unit.

France also got an early start in the race for colonies, but she finished well behind the leader, England, in the quality and quantity of colonies that she finally controlled. Germany and Italy, who started late in the race for colonies, did not secure many rich colonial prizes. Both of these countries obtained colonies, largely in Africa, but they were for the most part areas which were not particularly desirable. Germany, of course, was stripped of her colonies following the first World War.

The Economic Development of Colonies.—The degree of control exercised over the economic development of the colonies has varied greatly as among the mother countries. Some colonies have been left free to develop in their own way, while almost every phase of the economic life of others has been dictated by the nations in control. Quite often the mother country has definitely encouraged the production of essential foodstuffs and materials, or has discouraged the growth of industries which would compete with those already established at home. In any case, colonies have usually been furnished with capital for development through loans or direct investments, and have been aided in building transportation systems and securing credit facilities. The foreign trade of colonies is often controlled in the interests of the mother countries, which sometimes spend large sums to induce their citizens to emigrate to the colonies. Such inducements may include direct economic incentives to the emigrating people, free maintenance of law and order, and improvements designed to make life in the colonies attractive to prospective colonists.

Preferential Tariffs.—The methods by which nations attempt to reap the greatest possible economic benefits from their colonial possessions vary from case to case. One common method is the use of a preferential tariff system. Under such a system, lower duties are applied by the colony to products coming from the mother country than to identical products coming from other sources. Similar discriminations are made by the mother country in favor of the colony. Thus, the industries of the mother country are given the privilege of marketing their goods in the colony upon more favorable terms than those granted to producers in other countries. Whether or not this is a great advantage will depend, however, upon the size of the preferential duties, which may still be sufficiently high to give protection to colonial industries.

While important raw materials are allowed considerable freedom of entrance by most industrial nations, it is often possible for a colony to derive much benefit from preferential duties applied to its products by the mother country. If, for example, the mother country is applying protective duties to certain foodstuffs and raw materials in order to stimulate domestic production, or if it levies high duties on certain foodstuffs for revenue purposes, preferential duties may be a distinct advantage for a

PART 6

THE MECHANISM OF EXCHANGE



degree of control over its foreign relations, or possibly the right to intervene in its domestic affairs under certain conditions, in return for a guaranty of protection.⁴ Protectorates have often been set up when an industrial nation has hesitated to take the military action necessary to bring a backward area under complete control or when an attempt at annexation might have aroused the opposition of other industrial powers. Protectorates have, in general, furnished a rather unstable type of control over backward areas, for they have usually become outright colonies in due time or have achieved their independence.

However, they have, in their time, given the protecting nations certain important advantages. The protected countries have often agreed not to conclude any treaties with other countries, obtain any loans from other countries, or make concessions to the citizens of other countries without the consent of the protecting countries. The latter are often allowed to maintain troops in the protected areas, appoint governor-generals, and safeguard the personal and property rights of the citizens of the protected country who are located in other lands.

Mandates.—Some control over the development of backward areas has been enjoyed by certain nations under the so-called mandate system. This system developed after the first World War, under the auspices of the League of Nations. Under a mandate, an advanced state held a backward area in trust for the League of Nations, helping to administer its affairs until it was able to stand by itself. The mandatory state was expected to administer the controlled area for the benefit of the people of that area and not for its own advantage, and to maintain the "open door" policy with respect to other nations. That is, other nations had to be allowed to do business in the mandated territory, to make investments there, and to receive concessions for the development of resources. However, some advantages of an economic character are almost certain to be enjoyed by the mandatory nations from their control over backward areas.

Concessions.—Even in the absence of political control, it has often been possible for industrial nations to achieve a measure of control over backward areas by means of concessions. A concession is a grant of power, usually given by a country in which governmental control is weak and which is undeveloped economically, to individuals or companies of other countries to utilize mineral resources or otherwise develop an area, subject to certain rules and restrictions imposed by the granting country. Concessions may be granted for a variety of purposes, but the most important are probably plantation, mineral, and petroleum concessions.

While concessions are not usually made directly between nations, it is nevertheless true that national governments are greatly interested in concessions granted to their nationals. The struggle for the oil reserves of the

⁴ *Encyclopedia of the Social Sciences*, New York, The Macmillan Company, 1934, vol. xii, pp. 567-571.

be carried on at least moderately well by other means, the answer which one person would give to this question might differ widely from that of another. There are some few individuals even today who believe that the ideal condition of society demands a complete absence of government. Others believe that government is a necessity but that its duties should be kept down to a minimum, while still others would have all industries owned and controlled by the government—that is, by the people collectively rather than individually. Everyone would then work for the government; and it might be found wise, according to this opinion, to extend collectivism so far as to include the collective use of the products of economic processes.

A Test for Governmental Functions and Expenditures.—There is no necessary end or limit to the activities or functions of government. These activities might be reduced greatly from their present status, or they might be expanded until the government controlled all economic activity. It is merely a matter of what part of our real income we wish to acquire collectively, rather than individually. We greatly need a test which can be applied in deciding whether a given function involving a considerable expenditure should be assigned to a governmental unit or left in private hands.

We may get some notion of the nature of such a test by giving thought to the purpose for which governments exist. Functions are given over to governments to perform, with the idea that services will in this way be rendered more efficiently and cheaply than they could be provided by each individual for himself. Thus it may be said that a function should be delegated to the government only when it appears that, bearing in mind the necessary costs of administration in collecting and disbursing the funds together with whatever knowledge may be available as to the efficiency of the government in question, the expenditure of a given sum collectively will result in a more adequate and economical service than could be obtained by a similar sum privately spent.

A decision as to the aggregate amount to be collected and spent by governments in rendering the various services may be reached by having recourse to the familiar economic terms "satisfaction" and "productivity." Individuals spend their incomes for consumers' goods, usually after a consideration of the different amounts of satisfaction that are likely to be derived from the various alternative uses to which the funds in question might be put, or for producers' goods after a similar decision has been reached with regard to productivity. In other words, individuals tend to spend their incomes in such ways as will likely, all things considered, result in the realization of the greatest possible amount of satisfaction, or productivity, as the case may be. Applied to public expenditures, the principle as commonly stated is that additional funds should be collected and spent by the government just so long as the amount of satisfaction to

CHAPTER 31

THE PROCESS OF EXCHANGE

=====

The Relation of Specialization to Exchange.—In primitive industrial society people made goods chiefly for their own consumption. Under conditions of modern specialization an individual has no intention of consuming all, or even most, of his product. A specialist works with the deliberate idea of producing more of a given commodity or service than he himself can consume, so that he may exchange this excess for other commodities and services which have been created by other producers.

The farmer cannot consume all of the food products he raises, the tailor cannot wear all the clothes he makes, the contractor has no idea of occupying all of the houses he builds, nor has the surgeon any personal use for the large number of operations that represent his contribution to production. But these producers, who of course are specialists, have a definite desire for other commodities and services; and so, in effect, they take their surpluses of food, clothing, houses and surgical operations to other people, who give them in exchange shoes, automobiles, theatrical performances, and other economic goods which they desire.

Difficulties of Direct Exchange.—We have, then, exchange going hand in hand with specialization. Specialization would be out of the question without exchange, and exchange could hardly exist without specialization. The means by which exchange of commodities and services is effected are of several kinds. First of all is *direct exchange* or *barter*, which is the type resorted to in simple stages of economic society and which consists of trading goods for goods.

But barter becomes extremely inconvenient as specialization increases. Imagine, for example, the difficulties encountered by an instructor in economics who is trying by direct barter, instead of by money exchange, to convert his specialized services into other services and commodities. This teacher of economics, needing a suit of clothing, goes to a tailor, who is also a specialist, and offers to exchange five hours of economics for one suit of clothes. But if the tailor should not be interested in economics, our instructor would not be able to make a trade; and he might have some trouble in locating a tailor who would be willing to exchange clothing for training in economic principles. There is always a danger, then, that

the funds, for under such conditions the satisfaction of added services of the government to the people who receive them, but who could not provide the services for themselves, will probably greatly exceed the satisfaction lost by those who are called upon to furnish the funds. On the other hand, whenever there is relative equality of wealth and incomes and whenever a system of proportional taxation is used, governmental activities may well be on a much smaller scale. It will also be true that in such a community the need for many governmental activities, especially those of the social welfare type, will not be so great as where wealth and incomes are very unequal.

THE NEED FOR OUR PRESENT PUBLIC EXPENDITURES

On the basis of this test, does it appear that certain activities of our several governmental units should be curtailed or dropped entirely? We may first express doubt that any net social advantage would result from a decision not to have the governments carry on the various functions which they were performing in the regulation and guidance of economic activity prior to 1929. Nor does it appear that greater satisfaction would be created by leaving in private hands the funds now being collected and spent by the governments for various social purposes. The need for these services has come upon us gradually and inevitably with the changes that have taken place in our social structure, and it does not seem that the responsibility for performing these functions could have been avoided under any circumstances. Under present conditions it is unthinkable that such matters as education, highways, and the provision of institutions for the care of dependents, defectives, and delinquents should be neglected. On the whole, it must be said that the great bulk of these activities of governments may be expected to stand up under the scrutiny of the proposed test for public expenditures. That is to say, these activities create sufficient satisfaction for the receivers of the services, or for society as a whole, to more than compensate for the loss of satisfaction to individuals or damage to business which may result because funds are collected in order to make it possible to carry on these functions.

The Need for Expenditures for Protection.—However, there is ordinarily more doubt whether a similar conclusion can be reached with regard to what is usually the principal activity of the national government—the provision of protection in one form or another. Expenditures for this purpose, as has been mentioned, make up a very large part of the total expenditures of our national government, and consist in the main of payment for past wars and preparation for those of the future. Without attempting to ascertain whether the wars of the past were necessary or the extent to which maladministration may have added to the costs of these conflicts, we may note that there is a conviction on the part of many per-

in direct barter one of the parties in question will not care to receive what the other has to offer.

There is also the difficulty, in our illustration, of determining just how many hours of economics should be given in exchange for a suit of clothing. Perhaps one hour given by a master of the subject would be sufficient, whereas it might take a dozen hours of teaching by one who knew less of economics. The tailor, in our example, would probably not be able to decide the true value of the service which the teacher is offering, whereas the head of an economics department in a large university could appraise this particular service much more satisfactorily. Certainly the tailor would hardly be prepared to express the value of suits of clothing in terms of the many different kinds of economic goods that would be offered him under conditions of barter.

Or suppose that our instructor wishes to buy not a suit of clothing but a plate of ice cream. Shall he offer to the ice-cream dealer (say) two minutes of economic teaching? This would seem at first thought to be absurd, and yet he could scarcely afford to give more than two minutes in exchange for the ice cream, if his time were as valuable under a system of barter as it appears to be in a money economy. And, of course, the amount of good which the ice-cream dealer would derive from a discussion of that length would probably be almost nil.

There is the further fact that the services of this instructor must be used day by day if they are to be of any good. It is impossible for him to save up his teaching for a month, and then dispose of it all in one day as he might with material goods. Consequently, we may say that his services are perishable; and this is true not only of services but also of many kinds of material goods throughout economic society.¹

Advantages of Indirect Exchange.—Because of the inconvenience of barter exchange and the impossibility of carrying it on satisfactorily, we now usually employ either *money exchange* or *credit exchange*. In money exchange, the instructor of our illustration is paid in (say) dollars, and then, with each of these dollars or portions of dollars, he purchases from someone else those things which he needs for his comfort and well-being. Money is in effect a common denominator to which we reduce all commodities and services. Its conveniences are many, as we shall note in our discussion of money in the next chapter.

One of the greatest of these conveniences lies in the fact that money will be readily accepted by all members of an industrial society. Our instructor has no difficulty at all in getting the tailor to accept money in exchange for a suit of clothing, since the tailor may readily exchange

¹ An interesting example of modern exchange by barter is afforded by the Barter Theatre, of Abingdon, Virginia, to which admission may be gained by persons who present, at the box office, bread, cakes, fruit, vegetables, fowls, dairy products, and other commodities that are acceptable to the management.

pensitures for relief purposes were necessary in any case, during the depression; (2) most of the funds had to be furnished through the federal government; and (3) no administration of federal relief, however efficient, could have saved a sufficiently large part of the funds actually expended to have made any great difference in connection with balancing the budget.

Another expensive item in the depression activities of our government has been the assistance rendered to our farmers. Once again, the government may or may not have adopted the best methods for this purpose, and the gains that were realized may not have warranted the spending of so much money, but practically everyone felt in 1933 that business recovery was impossible so long as agriculture remained in a critical condition. To be sure, the agricultural problem might have solved itself in time, but few people wanted to wait for such an outcome. Even today both major political parties agree that the farmer must continue to have aid, and their quarrel is confined to methods and costs.

What person, familiar with the facts, would suggest that expenditures for the conservation of soil and other resources are a waste of public funds? Who would say that we should now be better off if millions of farmers and home owners had been allowed to lose their farms and homes because the funds used to protect them were left in private hands? How can one condemn these types of public assistance, and at the same time approve the lending of billions of dollars to railroads, banks, and insurance companies through the Reconstruction Finance Corporation? Many other parts of the government's depression program are highly controversial in character, but, unlike those which we have mentioned above, they are not so likely to be attacked from the point of view of their money cost, so that their discussion has been or will be conducted in other chapters.

PUBLIC BORROWING

The National Debt.—The expenditures for carrying on governmental activities should ordinarily be made out of current revenues from taxation and other sources. In recent years, however, all of our governmental units have found it impossible to secure sufficient current revenue to meet their expenditures, and have depended upon public borrowing to meet the deficit. Although the debts of state and local governments have also been increasing rapidly, we shall center our attention upon the national debt of the United States.

The public debt of the federal government reached \$26,597,000,000 after the first World War, but by 1930 it had been reduced to \$16,026,900,000.⁷ Since 1930, the government has had a large deficit every year,

⁷ Daily Statement of the United States Treasury, June 30, 1941.

these dollars for things which appeal to him more strongly than economic training. The instructor's difficulty of splitting up his specialized service into portions small enough to buy the plate of ice cream easily has also disappeared. Instead of a few minutes of economic discussion, he pays the dealer fifteen or twenty cents from his money income. The number of transactions of these kinds which are daily taking place results promptly in the establishment of definite prices, expressed in terms of money, for all commodities and services. Thus, there is no difficulty in finding out how much the instructor should give for the suit of clothing. The price has already been established at, let us say, \$50.

Finally, there is no need for the instructor to search for sellers who are willing to accept economics for their goods, since he may dispose of his services at a central point, a college or university, to which come buyers anxious for this particular service. In the absence of money exchange, it is entirely possible that these students of economics, eager for knowledge of the subject, would come to the university prepared to pay for their instruction in potatoes, farm machinery, street paving, medical service, and other kinds of desirable commodities and services which, however, would not be needed or accepted by the instructor. But in a money economy, they pay their tuition in dollars, some of which the instructor receives in payment for the service he renders.

Credit Exchange.—Money exchange is a form of indirect exchange, in contrast to barter or direct exchange. A second type of indirect exchange is that which is carried on by means of credit. Of recent years the amount of business transacted by credit has increased tremendously. Money exchange consists of giving money in return for commodities or services, whereas credit exchange consists of giving in return for commodities and services a promise to pay at some future date. The principle, of course, is precisely the same. When money is paid for a certain article the seller receives immediate purchasing power which he may use today if he likes. The only difference in credit exchange—that is, when a promise to pay at a future time is given—is the postponement of the actual transfer of purchasing power until the date stipulated in the agreement. Even this distinction is less important than at first sight it might seem to be, because in many instances it is possible for the seller of goods to convert the credit immediately into purchasing power by selling it to someone engaged in a particular line of economic activity—that is, in the purchase and sale of credit instruments such as promissory notes, or promises to pay. Nevertheless, credit exchange is in the nature of an incomplete transaction, since only half of the exchange has taken place, the other half remaining to be performed at another time.

If a farmer should buy an automobile, giving in payment tons of hay or bushels of wheat, he would be engaging in barter, or direct exchange. If he should pay cash for the car, it would be a case of money exchange,

there is no guaranty as to what the effects of future transfers of money income may be. Ordinarily, the transfer should not be very harmful.

THE CONTROL OF PUBLIC EXPENDITURES

The Need for a Changed Public Attitude.—While we may be justified in increasing governmental functions and expenditures rapidly in times of great national emergency, we need in ordinary times to bear in mind continually the direct relationship which exists between the functions of government and the cost of government. Our extravagance in handling public funds in the past may be traced in large part to the desire of individuals to get a full share of the seemingly inexhaustible store of wealth in the public treasury. Inefficiency and corruption in government flourish when the public attitude is one of indifference if not of condonation. It is necessary that the people be made to understand that there is no such thing as "government money" apart from the contributions of those individuals who support the government by the payment of taxes, fees, and the like. Every expenditure of public funds means inevitably a definite burden in the form of taxes either at that time or later.

When a person is heard to complain about the high taxes exacted by the federal government, he should be asked his attitude toward the American war program. If he believes that expenditures for this purpose are necessary and desirable, he should be willing to bear his fair share of the cost of the program. Again, it is scarcely reasonable or patriotic for one to demand that government funds be spent in his district for the erection of a courthouse or a post office or for the widening of a creek, unless he expects to contribute in tax payments to a fund that will enable other districts to have similar glorious but often quite unnecessary developments.

Indeed, as we have already pointed out, our legislators are able to obtain such appropriations for their districts only by cooperating with one another in a give-and-take fashion. Well-paved streets, magnificent highways, and ornate school buildings do not spring full-fledged from the ground. They can be constructed and maintained only at great expense, and this expense sooner or later must be borne by the taxpayers. Similarly, if the sight of human beings in want and misery causes a citizen's heart to bleed, so that he wishes them to be provided for by governmental action, he must remember that these functions of government will in the long run cause a drain upon his own purse. Surely a saner attitude toward public finance on the part of the people of the country will follow an understanding of the relation between taxation and public expenditures, and go far toward bringing about efficiency in the appropriation and administration of the public funds. However, once we have recognized fully that governmental activities are not free, but involve a definite cost, it is our privilege to decide calmly and deliberately what services

one type of indirect exchange. If he should get possession of the car by signing a contract in which he agreed to make twelve monthly payments covering the amount of his purchase, it would be an instance of credit exchange, a second type of indirect exchange.

The Use of Money in Exchange.—There is one point in relation to money which must be borne in mind throughout the entire study of economics. It has been mentioned before, but can scarcely be overemphasized. This is that money is essentially a means of exchange, and that ordinarily it is not desired for any purpose other than to exchange it for something else. If, for instance, the instructor in our example receives \$100 a week, this money is meaningless except as it provides the means to secure the economic goods he wants. In all probability, he would work without a money salary if he were guaranteed the commodities and services essential to a good standard of living. And the *number* of dollars he receives is likewise of no significance, except as it is translated into purchasing power. He would just as soon have \$50 a week as \$100, if the \$50 would buy as much in the way of commodities and services as the \$100 would buy. People do not desire money for the sake of the money itself, but for what it will buy.

These observations are made simply to emphasize the point that what men do is deliberately to create surpluses of commodities and services which, in the final analysis, they exchange for commodities and services created in surplus by other producers. Most of our economic thinking will be simplified if we can forget that money is ever resorted to in economic transactions. There are times, of course, when our economic reasoning relates to money, but in most instances (as we have observed before) it has to do with commodities and services.

The Gainers Through Exchange.—The question frequently arises as to who benefits when an exchange takes place. If, for example, I trade a fountain pen for a pocket knife, do I or does the other trader win? The answer is that in every free trade both parties expect to gain and ordinarily do gain. Having voluntarily given up the fountain pen in exchange for the knife, it is obvious that I am getting something which I would rather have than the thing I give up. The same remark applies to the other party in the trade.

If, however, I should conceal the fact that the fountain pen leaks, or if the other party professing to trade a good knife in reality trades one which has a broken blade, one of the traders may get the worst of the bargain. This, however, is not a trade but a swindle, since the true condition of the pen and knife was not set forth before the transaction took place. This question of exchange will arise again in connection with our discussion of international trade. For the present, it is enough to say that exchange consists of giving up things which are desired less by the

to pay taxes, the rates of taxation should be regressive, that is, a lower rate should apply to the larger incomes than to the smaller. Finally, if A's ability to pay taxes is more than double that of B, the rates of taxation should be progressive, that is, the greater the income the higher the rate of taxation which is applicable to it.

Diminishing Satisfaction and Income.—The advocates of progressive taxation base their arguments in large measure on the theory that the satisfaction to be derived from the expenditure of a unit of money income diminishes as the total income of the spender increases. A certain amount of income is necessary as a minimum for subsistence, and does not represent ability to pay in the true sense of the term. The first increments of income above this minimum amount are used by the individual to satisfy urgent wants, while further and yet further additions to income will be used to satisfy less and still less important wants. It follows that, unless we are dealing with individuals who choose to satisfy their less pressing desires before attending to those which are more urgent, diminishing satisfaction is experienced in the expenditure of successive increments of income. Thus, it is held that the man with an income of a million dollars a year is not losing nearly so much satisfaction when compelled to give up one hundred thousand dollars in taxes as is the man with ten thousand a year when he contributes a thousand dollars to the support of the government, although it is clear that the rate is the same in these two instances. It may seem equitable, then, for the recipients of large net taxable incomes to pay taxes at higher rates than those applied to men receiving smaller incomes, which means, of course, the use of progressive rates of taxation. Most students of public finance are content with progressive rates of taxation wherever they may at present be satisfactorily applied—which means for all practical purposes in the taxation of incomes and inheritances. It should be apparent that a progressive tax upon a commodity, say tobacco, which would mean a high rate if the purchaser were rich and a low rate if he were poor, would not be practicable.

Distributing the Burden of Taxation.—In the light of what is known about diminishing satisfaction in the spending of income, just how should the tax burden be distributed in order to follow the principle of ability to pay? Some writers suggest that the principle of equal sacrifice should be followed. That is to say, the distribution of the tax burden according to the principle of ability to pay is held to be perfectly realized when all taxpayers contribute such amounts that an equal loss of satisfaction, or an equal amount of sacrifice, is experienced by each. Other writers hold that the proper principle to follow is that of least aggregate sacrifice. According to this principle, no person should be required to pay any tax whatsoever so long as the same amount could be obtained from another person with a smaller loss of satisfaction—that is, at a smaller sacrifice

person relinquishing them than are the things which he receives in return.

SOME AGENCIES OF EXCHANGE

In direct exchange, or barter, the surpluses of some producers are exchanged for those of others, in order that they may be consumed by persons for whom they have greater utility than they have for the original owners. In indirect exchange, likewise, the problem involved is the transfer of economic goods from the original producer to the ultimate consumer.

Owing to the great size and complications of our modern economic society, this transfer is sometimes a very involved process and requires the assistance of many intermediate agents. The process is often referred to as the "distribution of goods"; and there is no objection to the use of this term, provided only it is not confounded with the "distribution of income" which (as we have seen) has to do with the division, among the owners of the factors of production, of the economic goods or "product" which these factors have jointly made.

Functions Performed by Agencies of Exchange.—The parts played by the several agencies of exchange may be made clear through the use of an illustration of comparatively simple exchange. A Virginia apple grower has picked and barreled his season's crop. He has, let us say, 5000 barrels of apples to dispose of. How shall he get them into the hands of the consumers? Clearly not by direct exchange, for the delivery of small quantities of apples to many thousands of housewives would be expensive and hopelessly drawn out. Several better methods are open to him. We may suppose that he has decided upon a plan often followed by fruit growers, that is, to retain ownership of the fruit until spring, when prices are likely to be higher than in the fall, and then to dispose of the crop through a commission house.

But this is an arrangement in which he requires assistance. He calls upon some of the agents of exchange for help. *Form* utility the farmer has already created, but *time*, *place*, and *possession* utility must be added before the apples are available for the consumers, that is, before they have been *completely produced*. Lacking storage facilities of his own, our farmer arranges with a storage concern in Washington to hold the 5000 barrels of apples from September until April. Thus time utility is created, for the apples will be more desired in April than in September, owing to the greater scarcity of the fruit in the spring months.

But the crop must be transported from the farm to the storage house; and this necessity entails, first, a transfer by truck to a nearby railway station, then a railway shipment to the city, and finally another transfer from the Washington freight depot to the storage plant. Each of these

income. However, the corporation income tax is open to certain objections, noteworthy among which is the suggestion that it does not conform to the principle of ability to pay. Many people contend that a corporation has no ability to pay taxes apart from the ability of its stockholders to pay. If this is true, the size of a corporation's net income bears no necessary relationship to its stockholders' ability to pay taxes. For one corporation with a moderate net income may distribute it in large amounts to its few stockholders, while another with a huge net income may hand this income in small amounts to its hundreds of thousands of stockholders. In general, this objection to the corporation income tax seems sound.

It is sometimes argued that this tax is objectionable because it results in double taxation, not only as between corporation and stockholder, but also as between corporation and corporation. Let us suppose, for example, that a corporation makes a certain net income, pays the tax on it, and declares a dividend. A part of the dividend may go to another corporation which owns a part of the stock of the first. This dividend payment becomes a part of the income of the second corporation and is subject to tax. In the case of a complicated holding company structure, this sort of thing might occur several times. However, this objection loses much of its force when we realize that under the present law 85 per cent of intercorporate dividends are exempted from taxation.

As between corporation and stockholder, the corporation pays the tax on its net income and then pays dividends to the stockholder. The dividends are personal income to the stockholder, and, under the present law, are subject to both the normal personal income tax and the surtax, if the dividend income is sufficiently large. This is unquestionably double taxation, but it seems to us that double taxation is bad only if it is *unintentional*, or if the total amount collected is unreasonably high. If double taxation is intentional, and the two taxes together impose only a fair burden upon the income affected, there seems to be little or no cause for complaint.

Incidence of the Corporation Income Tax.—It is doubtful whether this tax burden can be passed on to consumers of the products of these businesses in the form of higher prices, or whether any considerable portion of it can be transferred to the laboring group. If the tax should be passed on to the stockholders in the form of smaller dividends, a loss of capital and the eventual failure of some firms near the margin might result; and this situation, in turn, might make possible an advance in prices for the other firms and thus enable them to pass on some of the tax burden to customers. It seems likely that this will not happen, however, and that the tax will not be shifted. It is our intention in the present discussion to hold fast to what may be called the general principles of tax incidence, leaving the many qualifications and changes in assumptions which might

three steps in the journey, which may or may not have been performed by separate agents, adds place utility to the product, for the apples have made progress toward the ultimate consumer.

Having running expenses to meet, such as wages of labor, taxes, and so on, the farmer secures from his banker a loan to carry him over until the sale of the apples in the spring brings him an income. Since an immediate sale of the crop in the fall would have been necessary had the loan not been forthcoming, the banker must be credited with a part in promoting the storage; that is to say, he has aided in the creation of time utility. Moreover, the crop itself or the building in which it is stored (or both) will ordinarily be insured, so that the insurance company also is entitled to some credit in connection with time utility.

With the coming of spring, the apples are delivered to a commission merchant, sold by him to wholesalers (perhaps in hundred-barrel lots), thence to the retailers by the barrel, and finally to the consumers by the half- or quarter-peck. The commission man, wholesalers, and retailers are all merchants, and every transaction they carry on constitutes a creation of possession utility since each sale brings the product closer to its final destination, which is its possession by the consumers. It is probable that, in connection with these several sales, new place utility also was added, since a sale would usually involve the physical transfer of the goods also, in the case of a commodity such as we are now considering. (It would not be true, of course, in the sale of land—and other examples could be cited.)

In the case of many commodities, the goods would be advertised—another contribution to possession utility. Or they might be bought by speculators in anticipation of an advance in price, which would be an addition of time utility. Very important throughout the whole process is the use of money and credit, which will be described in detail in later chapters. These various agencies of exchange, it may be said, would find little or nothing to do in a primitive society, but it is inconceivable that an extensive economic order, such as we have today, could be carried on without their assistance.

Exchange, Marketing, Distribution.—The activities included in the “young profession of marketing”² are essentially the same as the functions of exchange outlined above, as may be seen by reference to any of the standard textbooks on the subject.³ The “marketing functions” stressed in these books are (1) “those involving transfer of title,” which are the equivalent of the theoretical economist’s *possession* utility, and (2) “those involving physical supply,” with special emphasis on transportation (*place* utility) and storage (*time* utility). The terms “exchange” and

² *Annals of the American Academy of Political and Social Science*, May, 1940, p. xi.

³ E.g., C. F. Phillips, *Marketing*, Boston, Houghton Mifflin Company, 1938; P. D. Converse, *Essentials of Distribution*, New York, Prentice-Hall, Inc., 1936.

Evaluation of Capital Stock and Excess Profits Taxes.—The capital stock tax yields a fairly stable annual revenue regardless of corporate earnings, but it may be burdensome to some firms in times of depression. The capitalization of corporations is an unsatisfactory index of their ability to pay taxes, for a corporation with large capitalization may have small earnings, and vice versa. However, the tax is small and is not progressive. The excess profits taxes produce anything but a stable annual income, though they may bring in large receipts in periods of business boom. In general, these taxes accord fairly well with the principle of ability to pay. A tax which appropriated all profits would be a bad tax, because it would prevent a corporation from offsetting, with the profits of certain years, the losses suffered in others. However, after a reasonable rate of return has been allowed as an offset to possible losses, further earnings may properly be regarded as surplus income and be subjected to taxation. Excess profits taxes are complicated, for it seems impossible to make them both fair and simple. They often give rise to extensive litigation and impose a severe test on the federal administrative machinery. Excess profits taxes cannot be shifted by the paying corporations, since they fall on realized surplus income after the business of the year is over.

Punitive Corporation Taxes.—We should note, in addition to the taxes already described, certain punitive taxes on corporations. In the past, the wealthy have often organized personal holding companies to receive and hold their incomes, in order to evade personal income surtaxes. There is now a tax on the undistributed net income of such companies, which takes 65 per cent of the amount of undistributed income under \$2000 and 75 per cent of the amount over \$2000. There is also a penalty surtax on corporations which improperly accumulate surpluses so that their owners may avoid personal income surtaxes. This tax is 25 per cent on the first \$100,000 improperly added to surplus, and 35 per cent on all additional amounts. Revenue derived from these taxes is reported under the corporation income tax. Finally, the "unjust enrichment" tax produced a small amount of revenue in 1941. This tax was levied a few years ago on corporations which had received, by order of the Supreme Court, processing taxes previously paid to the government, and which had already reimbursed themselves for these taxes by shifting them to others.

Proposed Change in Corporate Taxation.—Such is the veritable maze of taxes applied by the federal government to corporations. In addition, the corporations are subject to various state and local taxes. The federal government, as we have seen, taxes corporations not only to secure revenue from their income, but also to prevent the use of the corporate device as a means of evading personal income taxes and surtaxes. Much could be done to improve certain of these corporation taxes, but perhaps the greatest improvement would be to abandon the taxation of corporations and corporate incomes as such, at the same time bringing corporate

"marketing" may therefore be used interchangeably, with little if any loss of accuracy; and to these two may safely be added a third, synonymous term—"distribution"—provided only that this distribution of *goods* is not confused with the distribution of *income*.⁴

Costs of Exchanging Goods.—A great deal has been written about the high cost of exchanging, marketing, or distributing goods; and this cost is said to result, in turn, in the high cost of living. It is sometimes urged that the existence of large numbers of "middlemen," each demanding his share of income, needlessly increases the selling prices of many commodities.

The Twentieth Century Fund has made an extensive study of the cost of *distributing* economic goods, as compared with the cost of *producing* them in the first place.⁵ These investigators began by grouping together, as "production," all activities going into the creation of form utility, and as "distribution" the efforts involved in the creation of place, time, and possession utility. Allocating the 66 billion dollars spent for finished goods in 1929, they found that production cost 27 billion and distribution 39 billion dollars. This means that, on the average, approximately 40 per cent of the money spent that year for finished goods went to the producers while almost 60 per cent went to the distributors.

An average of this sort admittedly conceals many and wide differences in *production* and *distribution* costs as between commodities. In general, as is shown by data for more recent years, it costs more to get foodstuff to the ultimate consumer than to distribute manufactured goods. For example, the study of the Twentieth Century Fund indicates that distribution costs in the past decade accounted for the following proportions of retail prices of the goods listed: Cabbage, 82 per cent; carrots, 82 per cent; oranges, 73 per cent; shoes, 48 per cent; gasoline, 56 per cent;⁶ and cigarettes, 52 per cent.⁶ But the distribution costs of foodstuff are sometimes low (for example, 34 per cent for eggs), and those for manufactured goods are sometimes high (as in the case of rye whiskey, 79 per cent).⁶

It is the publication of figures such as these that arouses discussion as to whether we are not paying too much for the transfer of goods from the farm or manufacturing plant to the consuming public. The question is more easily asked than answered. The distribution costs of many commodities do seem to be disproportionately large. But if they are so in reality, why do not more capable business men enter the field, eliminate the wastes of distribution—if there are wastes—and thus undersell our present-day enterprisers? In some cases, the attempt is being made

⁴ Cf. chaps. 18 to 22 (vol. 1).

⁵ See Paul W. Stewart and J. Frederic Dewhurst, *Does Distribution Cost Too Much?* New York, Twentieth Century Fund, 1939.

⁶ Taking no account of taxes on the commodity.

nor are they even proportional to income. People with large incomes pay these taxes in greater absolute amounts than people with small incomes, but the percentage of total income spent for economic goods subject to excise taxes tends to decline as a person's total income increases. Therefore, these taxes take away a smaller *percentage* of a large than of a small income, and are regressive in operation. This does not mean that they should never be imposed, for their bad effects may be quite offset by other taxes in the system. Excise taxes have been good revenue producers in the past, and have been considered a rather elastic element in the tax system. Their convenience in collection and payment is well known, for they "get the feathers with a minimum of squawking." They are often included in the prices of articles in such a way that most consumers are unaware that they are paying them.

Customs Duties.—Customs duties, or duties on imports, produced only 5.0 per cent of the total federal revenue in 1941. These taxes have lost importance rapidly, for at one time they produced almost all the revenue of the federal government. The revenue from import duties is largely incidental at the present time. The United States is the world's leading exponent of the protective tariff. The primary purpose of our tariff act is to protect American industries by excluding foreign products from our markets. To the extent that the tariff is successful in this purpose, the consumers of this country are certainly burdened, and ordinarily to a greater degree than the protected manufacturers are benefited; but tariffs that actually exclude goods do not interest us in connection with our study of taxation, since they bring no revenue to the government. The rates applied to some imports, however, do not exclude the foreign products, and imports continue to come in despite the duties. In these instances, revenue results for the government. The import duties paid on commodities from abroad, regardless of how they are collected, ordinarily will have the same incidence as taxes on the production of domestic commodities; that is, they will fall on the final consumers. Hence, these taxes may be criticized in much the same terms as those applied to excise taxes above, except that the fiscal adequacy of customs duties may be more seriously open to question than that of excise taxes, since the primary object of our tariff is protection.

The Federal Tax System as a Whole.—In some respects, it is difficult to summarize our study of the federal tax system. Some of its taxes are direct, others are indirect. Some are convenient and economical to collect, others are not. Some are progressive, others are regressive. Certain generalizations may be made, however. The federal tax system as a whole ordinarily meets fairly well the test of fiscal adequacy. In depression or war years, of course, it sometimes fails to provide enough revenue to cover all expenditures which must be made, but it is difficult to imagine a tax system that would be perfectly elastic and adequate for all emer-

with varying degrees of success. But the benefits of "manufacturer-to-consumer" exchange are often more attractive in prospect than in practice.

The fact is that the consumer cannot, with any degree of satisfaction, deal *directly* with the manufacturer. If goods are to be manufactured cheaply, they must usually be made on a scale vastly larger than would be necessary to meet local needs alone. Some consumers, then, are too remote to be able to buy at the factory. And if they purchase through stores set up by the manufacturer, they are still, in effect, buying from a retailer (a distributor), even though the shop bears a manufacturer's name.

Unquestionably there is waste in distribution just as there is in the earlier stages of production, and perhaps even to a greater extent; and in both instances it should be done away with as thoroughly and speedily as possible. But there is a tendency to underestimate the services rendered by our agencies of exchange. It is easy enough to see that the baker is a productive agent. It is more difficult to give full credit to the truckster who hauls bread, and the grocer who sells it over the counter, simply because they are not creators of form utility. But the promptness and convenience with which one may secure bread depend upon the services rendered by the truckster and grocer quite as much as upon the productive effort of the baker.

"The laborer is worthy of his hire," and the distributor who performs a necessary function is entitled to payment. Without him, specialization as we now have it would be impossible. Perhaps the best evidence of his usefulness—though far from conclusive evidence—is our inability thus far to oust him, even though we recognize that prices are high and may suspect that the middleman is in some way responsible.

TWO ECONOMIC FALLACIES

Two misconceptions relating to exchange may be discussed briefly at this point. The first of these is referred to as the "keep money at home" fallacy, and the second is the "make work" fallacy.

"Keep Money at Home" Theory.—The idea that money should be kept at home rather than spent abroad is one which has been inherited from economists of the past. The falsity of the theory has been demonstrated time and again, and yet there are today business men, politicians, and others who apparently believe implicitly in its *soundness* and who argue vigorously in its defense.

The theory is usually expressed in about these terms: People of a given community—whether a town, a state, or a nation—should buy goods at home instead of bringing them in from the outside. By buying goods at home, home industries are encouraged, local business men prosper, there is plenty of employment for workers, and, as a consequence, prosperity

different, in their general approach, from the federal taxes on income. Income taxes are much less important for state governments than for the federal government. A few states have recently adopted income taxes which provide that their citizens must pay a flat rate of 1 or 2 per cent on their entire incomes, or on incomes above a certain very moderate exemption. Such taxes are, of course, proportional in character and do not correspond to the principle of ability to pay, although they may be productive of large revenue.

General Property and Inheritance Taxes.—The general property tax is important and worthy of examination, but it will be treated in connection with the tax systems of local governments, where it assumes even greater importance than in state taxation. Inheritance and gift taxes are used in 47 states, and yielded 2.8 per cent of state tax revenues in 1940. In most states, the inheritance tax is levied upon the several shares of an estate, rather than upon an estate as a whole—which means that it is truly an inheritance tax, and not an estate tax. State inheritance taxes are often progressive in two directions. That is, the rate grows larger the greater the share involved and the more distant the relationship, if any, between the decedent and the heir. The incidence of the state inheritance taxes is similar to that of the federal estate tax.

Sales and Use Taxes.—The sales tax has come into prominence, in recent years, as a source of revenue for state governments. The tax has been applied in about half the states, is based on retail sales, and usually runs from 1 to 3 per cent on the value of the articles sold. According to the data in Table 53, sales taxes and use taxes furnished almost 40 per cent of state tax revenues in 1940. Use taxes are usually intended to prevent people from escaping sales taxes—just as gift taxes are designed to keep them from avoiding inheritance taxes—and have been adopted by most states which use sales taxes. Use taxes are levied as a charge for the privilege of storing, using, or consuming within a state any goods which have been purchased outside the state. A person who lives in a state that has a sales tax, and who purchases goods outside the state to avoid the sales tax, becomes subject to the use tax when he brings the merchandise home. The receipts credited to sales and use taxes in Table 53 apparently include the revenues received from state excises on liquors, tobacco, gasoline, and other commodities, as well as those from sales and use taxes proper.

The sales tax—and this is true, also, of the use tax—is decidedly defective from the point of view of our principles of taxation; it is regressive in operation and does not conform to the principle of ability to pay. People with large incomes spend a smaller percentage of their incomes on the retail purchases subject to the tax than do poorer people, so that the tax takes a higher percentage of small than of large incomes. The sales tax is not so well received by the payers as some regressive taxes, for

for all. But if goods are purchased away from home, there is a lack of business for the home industries, and consequently a lessened demand for workers in local shops and factories.

This is the way the argument runs, but students who have followed carefully the line of reasoning in our discussion of exchange will realize that the "keep money at home" theory is a fallacious one. Buying goods means giving money, or purchasing power, in exchange for commodities or services. And the person who receives this purchasing power will use it, in turn, to buy commodities and services which he desires. In other words, every time we buy economic goods we engage in a trade, although it is more often indirect trade than direct barter. In every free trade, as we have seen, both parties benefit. It is obvious that we gain most when we spend our money where we get for it the greatest possible return in the way of commodities and services. If a distant merchant gives more or better goods than the local merchant for the same money, or the same goods for less money, certainly it is foolish for buyers to purchase their goods locally. If local industries are not able, in the long run, to compete with industries at a distance, then it would be economical to allow them to pass out of existence, since they have shown an inability to survive in the face of competition. Indeed, every plea to keep money at home is a confession of weakness on the part of those making the plea, for money will stay at home without urging if only it can be spent there as advantageously as away from home.

An interesting side light on the "keep money at home" theory is that those who preach it loudest frequently practice it least. The campaigns that dilate upon the dire consequences that will follow upon buying away from home are usually financed largely by the merchants of the town. But do these same merchants buy locally and thus keep money at home? Sometimes they do, to be sure, but only when local manufacturers and wholesalers will sell to them more cheaply than the manufacturers and wholesalers of other cities. In other words, they exhibit a pronounced tendency to do precisely what the consumer is inclined to do—that is, to spend their money where it will bring them the largest quantity of economic goods per dollar of expenditure. All they ask, of course, is to be allowed themselves to send money away from home and bring in goods which they can sell, at an ample profit, to people whom they have "educated" to think it disloyal and unpatriotic and—most perplexing of all!—uneconomic to buy anywhere but in the old home town.

Let us examine, for a moment, a town in which this fallacy has made no headway, and see what is happening in the way of exchange. Goods are being made in this town, but they are goods that the town is equipped to make advantageously. They are goods, therefore, that can to some extent be sold locally without recourse to methods of high-pressure salesmanship, since they are reasonably priced. But they can be sold also—

progressive rates, whenever possible, despite all protests against "soaking the rich," and not by an extension of taxes which are regressive in operation. Similarly, if the need for tax revenue should lessen, the regressive taxes should be eliminated or sharply reduced in severity, instead of cutting the rates which apply to incomes, excess profits, and inheritances. Every attempt should be made to increase the effective operation of these progressive taxes.

It is true that most of the regressive taxes are fairly satisfactory from an administrative point of view, since they are usually certain, convenient, and economical in collection. It is true, also, that when more revenue is needed in depression—a time when excess profits are but a memory and everyone's income is greatly reduced—it may be necessary to extend the use of excise, sales, and other taxes *as a temporary expedient*. Again, when the country is financing an enormously expensive war program, it may be necessary to extend the regressive taxes as well as increase the rates and lower exemptions in connection with the progressive taxes. But such extensions of the regressive taxes should be clearly recognized as emergency measures, and not accepted as permanent changes in our system of taxation.

The revenue system of the federal government is ordinarily capable of producing abundant revenue, but state and local systems have been less satisfactory from the point of view of fiscal adequacy. Moreover, it is unsatisfactory for both federal and state governments to tax both incomes and inheritances. Indeed, it might be desirable to have only one tax system in the United States. Under such a system, all taxes would be collected by the federal government and the revenue divided among the various governmental units. Finally, it would be desirable to extend the income tax downward until practically everyone with a money income would make some contribution, however small, to the direct support of the government, and would be aware that he was making such a contribution. This might aid in bringing about a public understanding of the relation between the performance of functions by the government and the necessity of contributing to the support of the government, and thus help to correct the present unwholesome, careless attitude toward public funds. The federal income tax has been changed in this direction to some extent in the last few years, as the government's need for revenue expanded under the national defense program.

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1. What is the nature of taxation, and how is taxation related to public expenditures?
 2. What is the problem of taxation?
 3. What is the first test of a sound tax system?
 4. If a tax system meets this test, what is the next most important consideration? Why?

and probably are sold chiefly—in other towns, again because they are made advantageously and the price is therefore low as compared with the prices of similar goods made less advantageously elsewhere. As finished goods move out of town, money flows in to pay for these goods, but some of this money flows promptly out again in payment for raw materials which must be brought in as the basis for more finished goods. People working in factories buy some goods at local stores; possibly they spend part of their wages with Sears, Roebuck and Company or Montgomery, Ward and Company, and thus *send money out of town*. But at the same time their employers are selling commodities that these people have helped to make—to Sears, Roebuck and Company, or Montgomery, Ward and Company, or some other out-of-town dealer—and thus *money is brought back into town*. Through these and similar transactions, money flows back and forth. If it goes out, it just as surely comes back again; and every time it facilitates an exchange between two parties, each of whom is performing some economic act that he is especially well fitted to perform, the money serves, as someone has well said, as a lubricant to the economic machine.

Keeping money at home means doing business only with the home folk, and not with those outside the community. Any group that adopted such a policy rigidly would, of course, be self-sufficient, and it would be bound to suffer in two ways. First, it would have to get along without some kinds of goods that it would like to have, since no community has yet been able to supply itself with everything it needs and wants, without assistance from other communities. Second, it would have to get along with smaller quantities of goods, since it would be making disadvantageously some goods which, had it not chosen isolation, it could buy cheaply from other communities equipped to make these same goods advantageously. It is very likely that such a community would have *more work to do* than before, but it seems quite certain that it would have *less of economic goods*. Anyone, then, who supposes that the goal of economic society is the *creation of work* is carrying his ideas to a logical conclusion when he advocates keeping money at home; but no one who thinks of the *creation of goods* as the goal should have difficulty in seeing that this goal is more quickly and more completely reached by cooperation between communities than by each community trying to be independent of every other community.

The people of a community as a whole are not injured by sending out money and getting commodities and services in exchange, though some individuals may suffer and be compelled to turn to new fields of production. The fact that money is spent indicates that the spenders are getting for it something which they prize more highly than the money itself. The fact that it is spent *abroad instead of at home* shows that local sellers offer less in exchange than sellers at a distance. All that

lion bushels from 1917 to 1919, and reached a peak of 293 million bushels in 1921. Cotton exports amounted to 5.3 million bales in 1916, but increased to 6.5 million bales by 1919. Tobacco exports were 348 million pounds in 1915, and 648 million pounds in 1920. Exports of corn, which are never very great, were 179 million bushels in 1921, as against 40 million bushels in 1915.⁴

Changes in Farm Incomes.—The gross farm income of the United States was \$7,028,000,000 in 1914, \$7,395,000,000 in 1915, \$15,101,000,000 in 1918, and \$16,935,000,000 in 1919. Even these large increases in income would not have meant much to the farmers if the prices of products they bought had increased as fast as the prices they received for their own products, but this was not the case. If the years 1909 to 1914 are taken as the base period for index numbers of both prices received by and prices paid by farmers, we find that prices received by farmers were 202 in 1918, while prices paid by farmers were 176. In 1919, these two index numbers were 213 and 202, respectively.⁵ Therefore, the farm income of this country increased both absolutely and in relative purchasing power during the war and early post-war years.

Post-war Demand and Supply Conditions.—But these favorable conditions for our agriculture did not last long. After the close of the first World War, agricultural production picked up in Europe so that within a few years many of the European countries had reached the pre-war level in this respect. As a result, their demand for American farm products declined. Moreover, many of the less highly industrialized parts of the world were able to increase their agricultural production substantially through the use of improved methods and machinery; and they began to compete strenuously for the foreign markets which Americans had been supplying with farm products. Some European countries were not content to have their agricultural production merely reach pre-war levels. Under the influence of programs of extreme nationalism, many attempted to become self-sufficient, or largely so, with respect to important foods and raw materials which they had formerly imported in large quantities. This they did despite the fact that their land areas were often poorly adapted to raising these goods, so that the costs of producing them at home were excessive.

The American policy of discouraging imports, as developed in our high protective tariff laws after the war, hindered our farmers in their efforts to retain export markets. The eventual and inevitable curtailment of the large loans Americans had been granting abroad for the purpose of financing exports increased the difficulty of selling farm products to foreigners. From the domestic point of view it may be true, as is often claimed, that changes in the diet of the American people had a depress-

⁴ *Ibid.*, pp. 458-461.

⁵ *Ibid.*, pp. 680, 681.

happens is that money goes out and commodities and services come in—more commodities and services than the community would have, had the money stayed at home by being spent there. In other words, there is released from the home town money which has no significance except as it is exchanged for goods, material or non-material; and there are brought into town economic goods which are capable of being consumed immediately or in the future, and which therefore yield genuine satisfaction.

Nevertheless, we are constantly admonished to patronize the neighborhood druggist, to support local merchants instead of mail-order houses, to buy articles manufactured in the home city, and to use goods made in the United States rather than those manufactured abroad. Political campaigns are sometimes waged on the basis of a protective tariff. And yet a tariff of this kind is simply an artificial means designed to force people to buy goods at home, rather than in a foreign country where the goods could be had more cheaply.

"Make Work" Fallacy.—The second error into which many persons fall has been termed the "make work" or "lump of labor" fallacy. The theory here is that there is only a certain amount of work to be done in a community, and it should be spread out so as to keep all workers employed. If people are out of employment, it is thought by some that the wise thing to do is to create work so that they may be employed. If, for example, men are idle in the winter time, it is regarded as a great blessing to have a heavy fall of snow so that these men may be able to earn an income.

From the economic point of view, it would be much better, of course, to put them to work shoveling dirt in the building of a subway instead of clearing snow from the sidewalks. If it is desirable to supply work to unemployed men at all costs, one could easily justify the deliberate destruction, by fire, of all, or a large part, of the buildings of New York, Chicago, or Philadelphia. An action of this kind would provide an abundance of work for builders of all types, and would be just as sensible as praying for snow in order to give employment to the unemployed; and yet there are few who would be so rash as to suggest that the kindling of such a fire would be desirable.

The "make work" fallacy is one which is said by some students of labor problems to be an actuating force among labor unionists. Some unions definitely set an amount of work to be done in a given time. Although labor leaders usually deny the charge, it is true that workers have sometimes decided that just so many bricks may be laid in a day, or so many cigars, and no more, manufactured in a given number of hours. A restriction of output of this kind is often caused by fear on the part of the workers that there will not be enough work to go around. Consequently, to make their work last longer they do less of it each day, al-

The first agreements that were drawn up often provided for minimum prices to both producers and distributors, but the fixing of minimum retail prices was later abandoned as a general principle. However, the distributors who purchased their supplies of milk from producers were required to pay fixed minimum prices, these prices depending upon the uses which were to be made of the milk. The highest price was paid for whatever was to be sold as fluid milk, and the lowest for milk to be made into butter. Different prices for milk were set for the various milk sheds. New producers were required to sell their milk at the lowest price for their district for a period of ninety days, and producers in general were expected to control their production according to the quantities they could sell as fluid milk and for other purposes.

Other Policies of the A.A.A.—In addition to the purchase of sows and little pigs, as previously noted, the Agricultural Adjustment Administration bought substantial amounts of butter and cheese for distribution to families on relief, through the Federal Emergency Relief Administration. However, the most comprehensive program of direct purchase was the governmental purchase of cattle, sheep, and goats in the drought area in 1934. Because of the drought, grain, forage, and pasture were exceedingly scarce in certain states, and water as well in some instances. The purchase of livestock by the government prevented the total loss that many farmers would have suffered without this timely aid, and to others brought prices superior to those which could have been had by marketing their stock through regular channels. Moreover, the purchases were directly in line with the Administration's program for reducing the production of farm commodities. The resulting edible products were distributed, as usual, to needy families through the Federal Emergency Relief Administration. We mentioned, in an earlier section, the Farm Credit Administration's policy of lending money to farmers on the basis of their holdings of certain basic crops.

The Increase in the Number of Basic Products.—In 1934, the list of basic products coming under the Agricultural Adjustment Act was amended to include beef and dairy cattle, sugar, peanuts, rye, flax, barley, and grain sorghums. Processing taxes and benefit payments were soon provided for sugar and peanuts. In 1935, Congress passed a very rigid production control bill for potatoes. The law provided that no farmer should raise and sell more than five bushels of potatoes without getting a permit from the Administration, and that allotments of the amount a person might raise would be assigned to each farmer. Any grower who exceeded his quota or failed to obtain a permit was subject to a tax of 45 cents per bushel on his excess production in the first case, and on his entire output in the second case.

All potatoes sold by farmers were to be marketed in closed containers prescribed by the Administration, and these containers were required

though demanding, of course, a full day's pay. In like manner, they oppose the introduction of labor-saving machinery on the ground that it would reduce the amount of employment available for hand workers.

Those who hold and express the opinions outlined above either have a mistaken notion of what exchange really is, or are arguing from the short-run point of view. The error arises through overlooking the fact that whenever commodities or services are created, they themselves constitute the purchasing power with which other commodities or services may be obtained. If, then, the unemployed got busy and made some article which the general public wanted, that article could be exchanged for the things which they themselves need. And, since human wants are capable of practically indefinite expansion, there should be plenty of opportunity for productive work, runs the argument. The difficulty, however, lies in *getting the opportunity* to make the thing which others are willing to buy. Since industry is conducted on a basis of workers employed by manufacturers and others, the workers are dependent upon employers for an opportunity to make those articles which can be exchanged for the commodities and services necessary to their well-being.

But employers will not manufacture such goods unless there is a demand for goods of this type; and oftentimes articles of a particular kind are manufactured in larger quantities than the actual demand warrants. As a result of an overproduction and accumulation of automobiles or radio sets, factories devoted to the manufacture of goods of these kinds may temporarily be closed down. This is exactly what happened in the Ford plant and other automobile factories some years ago. It is frequently said that there can be no such thing as *general overproduction*, since the wants of human beings are unlimited. But there can certainly be *more goods of a given kind* manufactured than will be taken from the market at a price sufficiently high to cover all costs of production, owing to the fact that manufacturers sometimes overestimate the demand for a particular type of goods. The word "demand" is here used to include not only the desire for an economic good, but also the possession of sufficient income to permit its purchase.

Whenever a man produces a good *which other people want and can afford to buy*, he creates purchasing power. For he can take his good and exchange it for some other commodity or service; and in so doing he, in effect, *purchases* something with the good he has made. It follows that there can never be overproduction so long as he and others produce the right kinds of goods, and each in the right quantity. When, a number of years ago, cheap automobiles were for several months a drug on the market, the situation did not arise from too much production, but from too great production of cheap cars. If the productive power used in manufacturing the surplus stock of cheap cars had been turned into the manufacture of, say, a strikingly new and advanced model, this new car would

war. When the question of the terms upon which the railroads should be turned back to their private owners was being considered, many different plans were evolved, and yet they all agreed more or less completely in one particular. This was that the growing transportation needs of the country demanded, through some method or other, the welding together of the many independent railroads, each formerly following its own self-interest, into an efficient national system of transportation. It appeared that only by some plan of consolidation or cooperation could economies in operation be achieved, and the railroad plant and equipment be efficiently utilized, while difficulties of rate regulation were being overcome.

THE TRANSPORTATION ACT OF 1920

The attitude toward the railroads described above received its first legislative expression in the Transportation Act of 1920. Under this legislation, the control of the railroads subject to the provisions of law was continued in the hands of the Interstate Commerce Commission, the agency set up for that purpose in 1887 by the Act to Regulate Commerce. The Interstate Commerce Commission is made up of nine members, appointed for terms of seven years each by the President of the United States with the consent of the Senate. The work of the Commission is expedited by the provision that it may organize itself into as many divisions, of not fewer than three members each, as may be necessary to handle its business, and that each division may act independently of the others, with its decisions subject to reconsideration by the Commission as a whole. The Act of 1920 placed upon the Interstate Commerce Commission some new responsibilities which were expected to be of great import in connection with the solution of the railroad problem. We shall consider the provisions of the law and their operation under four headings—railroad consolidation, rates, securities, and service.

Railroad Consolidation.—In the first place, the Act of 1920 was noteworthy in that the traditional emphasis on competition in the railroad industry was discontinued. The Interstate Commerce Commission was ordered to prepare and adopt a plan for the consolidation of the many railroads of the United States into a limited number of systems. In drawing up such a plan, the Commission was asked to bear two considerations in mind: (1) To preserve as far as possible the existing conditions and channels of trade, and (2) to make each system such a combination of weak and strong roads that, when uniform rates are applied throughout the country, each system will make substantially the same rate of return upon the value of its property devoted to the transportation service as that made by the other railroad systems. Under the consolidation plan (whenever formulated by the Commission), it was made lawful for two or more railroads to consolidate their properties for ownership, manage-

probably have sold in fairly large quantities to persons of wealth. Until human wants have been completely satisfied, there can be no such thing as *general overproduction*, though, as we have seen above, there may be and often is *misdirected production*—that is, the production of more goods of a certain kind than people wish to possess or are able to buy.

But fine distinctions between general overproduction and misdirected production are not likely to interest a worker who is confronted by a concrete problem which may be expressed in the form of the question: "Where can I secure employment?" Though, from the social point of view, there is no economic justification for "making work," yet from the practical, individual point of view no further justification is needed than the fact that if the worker proceeds at a goodly pace, he will soon be out of a job, whereas, if he restricts his output, he may have steady, continuous employment. Furthermore, the shovelers of snow in our illustration are amply justified in giving thanks for the jobs that have been sent them; for, though the snowstorm has brought no economic gain to society as a whole, these individual workers have been enabled to secure purchasing power which may be the means of warding off starvation.

Of course, if all workers in society were to increase their efforts and, as a result, their output, there would be more commodities and services for all, and the scale of living of all members of society could be raised. Moreover, there would be no difficulty in finding a demand for the additional goods, provided care were taken to produce the kinds of commodities that were wanted, since (1) human wants are far from being completely satisfied, and (2) every good produced constitutes in itself a demand for other goods. For example, if production of all kinds were doubled, a cigarmaker who now owns an automobile could have a second car or, if he preferred, could have in its stead a host of other less costly items, such as a radio set, a dress suit, a vacation at the seashore, and so on. These additional commodities and services would be his reward for having doubled his production of cigars.

But the scheme would work equitably only if there were a *general* increase in production. If only the cigarmakers were to double their output, the effect would be a much lower price for cigars, and smokers would benefit correspondingly. But there would be no gain for the cigarmakers, since the goods which they buy would not have increased in quantity and therefore would not have gone down in price. Consequently, though it is quite true that each of us *should* produce as much as possible, there is no assurance of personal benefit unless there is a general movement in the direction of maximum production. From the purely selfish point of view, restriction of output may often be a wise practice to follow.

And so, in applying the label "economic fallacies" to certain theories or ideas which seem to involve unsound reasoning, we should bear in mind

to protect other forms of transportation, but rather to improve and stabilize conditions in the motor carrier industry itself, the competition of motor carriers has affected the railroads so seriously in the past that we may well consider briefly the provisions of the Motor Carrier Act.

Provisions of the Act.—The law applies to common carriers, contract carriers, and brokers, engaged in interstate commerce by motor vehicles, but not to private carriers, except possibly with respect to safety regulations. The Act gives the Interstate Commerce Commission authority to prescribe rules governing employees, hours of service, and standards of equipment in the motor carrier industry. The numerous exceptions to the application of the law include school busses; taxis; hotel busses; motor vehicles operated by the Department of the Interior in the National Park service; motor vehicles used by farmers; motor vehicles of cooperative agricultural associations; trolley busses operated by electric power; motor vehicles carrying livestock, fish, and agricultural commodities exclusively; motor vehicles carrying newspapers exclusively; transportation within municipalities and adjacent areas; and casual, occasional, or reciprocal transportation by a person not engaged in transportation as a business.

Common carriers must secure certificates of public convenience and necessity, and must show the need for their service and their willingness and ability to perform it. Their business may include movements between fixed terminals and over regular routes, and only such business, but equipment and facilities may be added freely. Contract carriers must secure permits to operate, and must show the need for their service, their ability to perform it, the nature of the goods to be transported, and the territory to be served. They do not operate between fixed terminals, or over regular routes. Brokers, or persons other than carriers and their agents who sell transportation which is subject to the Act, must secure licenses, and show the need for their service and their ability to perform it. Common carriers already in operation on June 1, 1935, contract carriers in operation on July 1, and brokers in business on October 1, were allowed to secure certificates, permits, or licenses without further proof by making proper application before the last available date as fixed by the Commission.

Common carriers must file rates and abide by them, subject to heavy fines for transporting without filing rates or for charging rates other than those on file. The rates must be reasonable and non-discriminatory, and may be changed only upon thirty days' notice to the Commission and the public. Contract carriers need file and publish only minimum rates. They may charge more than these rates, but changes in the minimum rates require thirty days' notice. The Commission does not have authority to prescribe the original rates for the motor carriers, but upon complaint or on its own initiative it may suspend and investigate any rates except the original ones. It may investigate the lawfulness of the rates on file and

the fact that these theories, while fallacious from the point of view of economic society as a whole, and in the long run, may be entirely sound, as looked at by the individual business man or worker, and considered as short-run phenomena. Since self-interest is a familiar characteristic of present-day economic society, it is not surprising that individuals sometimes follow courses of economic action which seem likely to benefit them in a material way, even though they do so at the expense of the general public. There is no lack, in current economic life, of examples of conflict between individual and social interest.

1. It is said that exchange goes hand in hand with specialization. Explain the relationship between the two.
2. Why would it be difficult, if not impossible, to carry on present-day exchange by means of barter?
3. In what ways does indirect exchange solve the difficulties connected with barter?
4. Money is referred to as "a common denominator to which we reduce all commodities and services." How does money as "a common denominator" facilitate exchange?
5. Distinguish between "money exchange" and "credit exchange."
6. Classify "barter," "money exchange," and "credit exchange" as, respectively, *direct* or *indirect* exchange.
7. "People do not desire money for the sake of the money itself." Explain.
8. How is it possible for a gain to be realized by both parties to a trade?
9. In modern economic society exchange is sometimes a very involved process. Name some "agencies of exchange" that assist in the process.
10. Why must care be exercised to avoid confusion if one uses the term "distribution" in speaking of the exchange of goods?
11. Recalling the definition of "production," state whether "agencies of exchange" may properly be thought of as producers. Explain.
12. Comment on the relative cost of *production* and *distribution*, as indicated by examples cited by the Twentieth Century Fund.
13. Why is "manufacturer-to-customer" exchange difficult to put into successful practice?
14. Without the assistance of agencies of exchange, "specialization as we now have it would be impossible." Defend or refute this statement.
15. State briefly the usual argument advanced in support of the "Keep Money at Home" theory.
16. "It is obvious that we gain most when we spend our money where we get for it the greatest return in the way of commodities and services." Does this mean buying at home or away from home?
17. Show the connection between a protective tariff and the "Keep Money at Home" theory.
18. According to the "Lump of Labor" theory, there is only a certain amount of work to be done in a community. Is this true? Why or why not?
19. How may a belief in the "Make Work" theory lead to restriction of output on the part of workers?
20. How may the expansibility of human wants be used in proving the fallacy of the "Make Work" theory?

commonly between 36 and 50 per cent of the rates on first-class freight. In some cases, flat railway rates on loaded trucks, trailers, semi-trailers, or "containers," when loaded with almost any kind of freight, have been authorized by the Interstate Commerce Commission.

The railroads have long charged lower rates for carload shipments than for less-than-carload lots of freight, but there have been no special rates for shipments involving several carloads or even a trainload, and no gradations between the carload and less-than-carload rates. Recently, however, the Interstate Commerce Commission has permitted some railroads to fix lower rates for multiple-carload shipments than for carload lots; and the railroads may thus be able to recover some of the freight traffic that has been moving by water in cargo lots. The railroads have also begun to establish graduated "volume rates" for large less-than-carload shipments. For example, the less-than-carload rate may apply to shipments up to (say) 5000 pounds, a somewhat lower rate to shipments between 5000 and 10,000 pounds, a still lower rate for shipments from 10,000 to 20,000 pounds, and so on until the rate is reached for full carload lots.

While these changes in railway freight rates have been developing, the motor carriers have moved in the direction of the rate-making policies of the railroads. In many cases they now use railroad classifications of freight, or very similar classifications, and their freight rates are the same, or almost the same, as those of the railroads. However, common carriers by motor can scarcely afford to adopt railroad freight classifications and rates unless the contract carriers can be made to do the same, or unless the trucking operations of contract carriers and of industrial or other firms can be restricted. In general, the movement of motor carriers toward railroad freight classifications and rates seems undesirable, for its completion would deprive the public of the economies of motor transportation. Motor carrier rates should probably be allowed to rest on the competitive basis of cost of service, with business divided between the railroads, motor carriers, and other transportation agencies on the basis of convenience, efficiency, and cost.

Water Carrier Regulation.—While the Motor Carrier Act brought another large section of the transportation field under the jurisdiction of the Interstate Commerce Commission, the Commission had only limited control over water carriers. That is, where joint rail and water routes were used, and in the cases where railroads were allowed to own water-carriers, the Commission had jurisdiction. There was great need for the regulation of water carriers, comparable to that which had been applied to railroads and motor carriers. In the Transportation Act of 1940 that need was met. With the exception of contract water carriers which do not compete with common carriers, and common or contract water carriers of commodities in bulk whose cargo space is not used for

21. Distinguish between "general overproduction" and "misdirected production."
22. Why is it impossible for "general overproduction" to exist in the long run?
23. How could the scale of living of all members of society be raised?
24. "There is no assurance of personal benefit [through an individual producing as much goods as possible] unless there is a *general movement* in the direction of maximum production." Explain.
25. "From the purely selfish point of view, restriction of output may often be a wise practice to follow." Why?

REFERENCES FOR FURTHER READING

- BLACK, J. D., *Production Economics*, New York, Henry Holt & Company, Inc., 1926.
- MARSHALL, ALFRED, *Industry and Trade*, London, Macmillan & Co., Ltd., 1920.

ing goods, and their rates are more likely to be based upon cost of service than upon what the traffic will bear. Unlike the railroads, motor and water carriers do not often have a monopoly with respect to a large part of their traffic, and are unlikely to practice discrimination and charge exorbitant rates. Finally, motor and water carriers can more readily adjust their facilities to increases or decreases in the volume of current traffic.

These considerations suggest that the regulation of rail, motor, and water carriers in exactly the same ways and to exactly the same extent would fall short of the stated objective of fairness and impartiality in regulation. However, it does not follow that motor and water carriers should be unregulated. The failure to regulate them would be unfair to the railroads, and would neglect the interests of the country as a whole, since motor and water carriers serve the public, enjoy public assistance, and make use of public property. Moreover, it does not follow that motor and water carriers should not be controlled by the same commission which controls the railroads. Unification and centralization of regulation in a single commission may be desirable, even though there should be differences in the nature and extent of regulation as between types of transportation.

The Case for Governmental Ownership and Operation of the Railroads.

—There are many people who believe that the railroad problem cannot be solved under a system of regulation, and that the federal government should take over and operate the railroads. Indeed, former Coordinator Eastman himself suggested that governmental ownership and operation may eventually be the best solution of our railroad problem. Those who hold this view advance many arguments in its support. In the first place, it is said that under governmental ownership and operation the objective would be efficient transportation and the promotion of the public welfare rather than private profits. It would only be necessary for the railroads to be self-sustaining under governmental operation; and profits, when made, could be used for the benefit of the general public or distributed in advance to railroad users in the form of lower rates, more adequate and safer service, or freedom from labor disputes through the payment of high wages to the railroad employees.

In the second place, it is contended that the management of the railroads would be as efficient under governmental ownership and operation as under private management—if not, indeed, more so. The railroad system, under governmental operation, would realize to the fullest extent those savings to be obtained from unified management—savings such as were realized under governmental operation during and after the first World War and which were among the chief objectives in the plan for voluntary consolidation described in this chapter. Moreover, the cost of regulation would no longer exist and a saving in interest charges would

CHAPTER 32

THE PRINCIPLES OF MONEY

WE HAVE made several references in preceding chapters to the usefulness of money in facilitating the process of exchange. We shall now go into the subject at greater length, describing the nature of money and explaining the functions it performs in a highly developed economic society.

MONEY IN THE UNITED STATES

Since most of our illustrations will be drawn from monetary practice in this country, it will be helpful to have before us a list of the several kinds of money that play a part in our monetary system. They are as below:

TABLE 33.—KINDS AND QUANTITIES OF MONEY IN THE UNITED STATES¹
(July 31, 1941)

Gold.....	\$22,674,679,987
Gold certificates.....	(20,379,688,503)
Standard silver dollars.....	547,077,816
Silver bullion.....	1,443,537,446
Silver certificates.....	(1,919,711,445)
Subsidiary silver.....	455,436,524
Minor coin.....	202,039,173
United States notes (greenbacks).....	346,681,016
Federal Reserve notes.....	7,191,679,375
Federal Reserve bank notes.....	20,396,189
National bank notes.....	150,970,270
Total.....	\$33,032,497,796

Many people who have been using American money for years are surprised to learn that we have so many kinds of acceptable currency. A few words of explanation about each of these items will help to clear up the situation. Separating the items into two groups (metallic money and paper money), we shall examine them briefly. Our new grouping gives us the following outline:

¹ From *Circulation Statement of United States Money—July 31, 1941*, issued by the United States Treasury Department. The figures in parentheses are not included in the total, since they are included in other items in the table. Omitted from the table are treasury notes of 1890, which are included in the government statement but “are being canceled and retired on receipt.” This item is of slight importance, amounting to little more than one million dollars.

be paid if the railroads should make the fair rate of return on their investment that was prescribed by the Commission. In other words, a saving could be realized through forsaking the profit motive, if efficiency of management could be maintained.

The question of efficiency of management is crucial. The arguments advanced above, supporting the view that governmental ownership and operation would be efficient, are all sound enough, but they leave out of consideration one very important factor—the human element in management. From a mechanical point of view, the railroads under governmental ownership would be organized in the form which appears most conducive to efficient operation; but what about the managers in charge of railroad operation? It might be difficult to find men of sufficient ability to manage a national railroad system successfully, for the railroad industry as a single unit would make the largest present industrial concern appear as a mere dwarf by comparison. Even if these “super-managers” exist, it is doubtful whether they would be chosen under our governmental system, in which political motives usually appear to control appointments—at least in part. If the right men were found by some method or other, would the government pay salaries high enough to attract them into the railroad service? Finally, if satisfactory managers could be attracted to the railroad industry, it is doubtful whether they would work as hard to hold down a job furnished by the government as one under private control of the railroads where their positions and salaries were dependent upon the results produced for the stockholders. Unless some way could be found to control satisfactorily the personal element in railroad management under government ownership, it appears that adequate service at reasonable rates might more readily be attained under regulated private management.¹²

In connection with the question of efficiency of management, it has been asserted that, if the government had owned and operated the railroads during the years from 1930 to 1935, it would probably have incurred a railroad deficit of \$10,000,000,000. The railroads under private management reduced operating expenses sharply during the depression years, while the government probably could not have done so, because of political pressure. In 1933, operating expenses for our railroads were 73 per cent of gross earnings, but operating expenses were 105 per cent of gross earnings in Germany, 107 per cent in Belgium, 112 per cent in Norway, 114 per cent in Denmark, 118 per cent in France, and 119 per cent in Italy.¹³ In these foreign countries all or part of the railroads were owned and operated by the government prior to the Nazi invasion.

¹² For a thorough and impartial discussion of this and other points concerning governmental ownership and operation of the railroads, see Elliot Jones, *Principles of Railway Transportation*, New York, The Macmillan Company, 1924, pp. 499–544.

¹³ *Railway Age*, April 18, 1936, p. 699.

I. METALLIC MONEY:

- A. Gold bullion
- B. Standard silver dollar
- C. Silver bullion
- D. Subsidiary coin:
 - 1. Silver:
 - a. Half-dollar
 - b. Quarter-dollar
 - c. Dime
 - 2. Other metals (minor coin):
 - a. Five-cent piece (of copper and nickel)
 - b. Cent (of copper, tin, and zinc)

II. PAPER MONEY:

- A. United States government obligations:
 - 1. Gold certificates
 - 2. Silver certificates
 - 3. United States notes (greenbacks)
- B. Bank obligations (guaranteed by United States government):
 - 1. Federal Reserve notes
 - 2. Federal Reserve bank notes
 - 3. National bank notes

Gold Bullion.—Gold is the basis of the monetary system of the United States, and every piece of money, whether metallic or paper, is measured nominally in terms of the "gold dollar." Prior to 1934, the dollar was defined as 25.8 grains of gold nine-tenths fine. But the Gold Reserve Act of 1934 authorized the President to reduce the gold weight of the dollar by not less than 40 per cent or more than 50 per cent; and on January 31, 1934, President Roosevelt by proclamation changed its weight to 15 5/21 grains of gold nine-tenths fine. The term "nine-tenths fine" refers to the purity of the gold bullion, and means that it consists of 900 parts pure gold to 100 parts of copper alloy.

The gold coin which circulated in the United States before the passage of emergency banking legislation in 1933 actually contained 25.8 grains of gold of this degree of fineness, for every dollar of face value. But gold coin and gold bullion, as well as gold certificates, were "called in" by the President of the United States, by authority of the Emergency Banking Act of March 6, 1933. Monetary gold did not circulate extensively in the United States even before that date, but was used chiefly for bank reserves and for the payment of balances arising out of international trade. It has now been wholly removed from domestic circulation, the gold coin reduced to bullion, and the total stock is now held in the United States Treasury as security against outstanding issues of United States government paper money. However, it can still be obtained, in quantities and at times approved by the Secretary of the Treasury,

PUBLIC UTILITIES

THE RAILROADS, which were discussed in the preceding chapter, are regarded as public utilities by some writers, while others, though admitting that railroads are "public utilities" in many essential respects, prefer to treat them separately. This separation makes for convenience in discussion, for the railroads have been regulated very largely by the federal government, while the control of the public utilities has been carried on almost entirely by the state governments.

THE NATURE OF PUBLIC UTILITIES

Natural Monopolies.—It is not easy to draw up a complete list of public utilities, since the items included under this heading change from time to time. Among the activities which have been classed as public utilities at one time or another are street railways; water, gas, electric, telephone, and telegraph companies; steamship lines; grain elevators; and stockyards—in addition to the railroads. When used in conducting such activities, private property is no longer strictly *private*, because in such uses it becomes "affected with a public interest."

What is it that causes a business to be classed as a public utility? One thing is the possession of the characteristics which make it a "natural monopoly." A natural monopoly is a type of business in which competition usually results in duplication of equipment and great waste. Imagine, for example, the waste which would occur if a city were served by two competing street railway systems, with duplicate tracks throughout the town, and duplicate rolling stock, power lines, and operating personnel. Each of these companies might be confidently expected to have a higher cost of production per unit of service than the cost would be if a single transportation company were operating in this city.

Most public utility businesses require a huge original investment in plant and equipment, and have large fixed or overhead costs. Such businesses enjoy increasing returns as they increase the volume of business transacted with a given amount of productive facilities, since the additional business increases only operating costs, and not fixed costs, while

for use in international trade. Despite the fact that gold no longer circulates as money in this country and that other forms of money are no longer redeemable in gold, the dollar continues to be defined as a specified amount of gold, and this amount is at present 15 5/21 grains nine-tenths fine.

Standard money is money which contains the amount of metal necessary to make its value as bullion exactly equal to its value as money. Since gold coin and gold bullion have been the only forms of money in our monetary system having a bullion value exactly equal to their money value, they have constituted the only strictly standard money we have had. The restrictions that were placed upon the use of gold in 1933 have brought about a situation in which there is no standard money in general circulation in this country, though there is a large stock of gold bullion in the United States Treasury.

Standard Silver Dollars.—Our so-called standard silver dollars are a relic of the bimetallic period of the country's monetary history, when the silver dollar, as well as the gold, was equally valuable as money and bullion, and was therefore genuinely "standard." The silver dollar contains 412.5 grains of silver nine-tenths fine, and is now worth as bullion only about 26 cents. This being the case, it might properly be placed under the classification of "subsidiary coins," which will be dealt with in a later section; but we have followed the time-honored custom of giving the silver dollar a separate heading.

Silver dollars pass freely from person to person in certain parts of the country, particularly in the Far West, where they seem to enjoy higher favor than paper dollars; but, because of their weight and bulk, they are extremely unpopular in some sections of the United States. Of the 547 million silver dollars in existence on July 31, 1941, only 54 million were actually in circulation. The others were held in the Treasury, and silver certificates circulated in their stead.

Silver Bullion.—This item is of recent origin, having arisen almost wholly out of the operation of the Silver Purchase Plan, which will be described later in the chapter. We shall see that the government can make about \$1.80 worth of silver coin from every dollar's worth of newly mined American silver bullion that it buys. Hence, the purchase of silver leads to a large "profit" to the government, and has led to the accumulation of silver bullion. This stock of silver (which may be expected to increase materially with the passage of time) may later be put into circulation through coinage or through the medium of silver certificates.

Subsidiary Coins.—Subsidiary coins are issued by the government because of the need for coins smaller than a dollar in a host of everyday transactions. Silver is used for the coins of larger values, such as the half-dollar, quarter-dollar, and dime. Its use in coins of lesser value than the dime would result in pieces of money so small as to be extremely

stock represents the present value of its property. About all that can be said for this method is that a valuation could be readily obtained by finding the total value of the company's stock on the stock exchange. Such a valuation would be most unsatisfactory, however. The value of the company's stock depends largely upon the rate of return which prospective owners hope to obtain by holding it, and the total value of its stock tends to be its present and probable future rate of earnings, capitalized at the current rate of interest. Since the total value of the stock depends upon the company's earnings, to make the earnings dependent upon the total value of the stock would be to reason in a circle. If a company were at present making an excessive return upon its actual investment, its stock would tend to sell well above par. And if the present value of its stock were taken as its valuation, a fair rate of return on this valuation would permit the continuance of an excessive rate of return upon the actual investment.

Original Cost.—If we were to use prudent investment cost as a method of valuation, it would be necessary to find a satisfactory method of converting the term into action. This might be done, it is often said, by taking prudent investment cost to mean the actual original cost of a public utility's properties, adding the cost of additions and improvements, and deducting any depreciation in the properties or loss of assets. It is argued that such a valuation is eminently fair to all concerned. It grants a public utility a fair return on the capital actually invested in the business, as of the present time, and the utility has no right to claim better treatment. Moreover, it protects consumers from having to pay rates which would give the company a fair rate of return upon an excessive valuation of its properties. Finally, the valuation on the basis of original cost, once ascertained, would not change except when actual changes in investment occurred in the future, and it would provide a stable basis for rate regulation.

But there are some drawbacks to this method of valuation. One is the obvious difficulty of ascertaining original cost. Many public utility properties were acquired long years ago, and records of the transactions may have been lost or destroyed, if indeed they were ever kept. If a company originally acquired property by giving the owner stock instead of cash, should the original cost of the property be construed to be the par value of the stock given, or an estimate of its cash value at the time? Or if, at some time in its career, a company has bought out competitors, either through cash purchase or the exchange of securities, and, in order to be rid of the competitors, paid an excessive price for their properties, should original cost be interpreted to mean the price actually paid or only the construction value of the properties? Should an allowance be made the company for the original cost of promoting the company, of building up good will, and of acquiring a franchise and, if so, how large an allow-

inconvenient. Consequently, the five-cent piece and cent (which are often called "minor coins" or "tokens") are made chiefly of copper.

Like the silver dollar, subsidiary coins are much less valuable as bullion than as money, and consequently are not standard money.

Gold and Silver Certificates.—Gold certificates bear a close relationship to gold coin and bullion, and silver certificates to standard silver dollars, since they are issues of paper money certifying the actual deposit of the gold or silver, as the case may be, with the Treasurer of the United States. The *gold certificates* are rather closely held by the Treasury and Federal Reserve banks, and of the total of some 20 billion dollars' worth in existence only about 62½ millions are "at large." Even these are not actually in circulation, but probably have been destroyed, mislaid, or are in the possession of those who do not know, or have disregarded, their legal obligation to turn these certificates over to the United States Treasury in exchange for other money. Prior to 1933, gold certificates were redeemable in gold upon demand, but they can now be redeemed only by Federal Reserve banks at the discretion of the Secretary of the Treasury. Furthermore, they are redeemable only "for uses authorized by law."

Silver certificates are allowed to circulate much more freely. About 12 per cent of all silver certificates are held by Federal Reserve banks, the other 88 per cent (or about 1 2/3 billion dollars' worth) being used in everyday business transactions. Moreover, they are readily redeemable at the Treasury in silver dollars.

United States Notes (Greenbacks).—United States notes, which are better known as "greenbacks," are a government obligation which dates back to Civil War times. Issued in 1862, they had for a time a value of only 35 cents on the dollar. From 1879 to 1933 they were convertible into gold, and the Treasury maintained a fund of about 156 million dollars in gold for the redemption of these notes. Relatively few, however, were presented for redemption, and they circulated quite as freely as any other American money. The gold redemption fund referred to above is still intact, but is not being used for paying off these notes. However, United States notes are redeemable in lawful money at the Treasury. They are an interesting example of inconvertible paper money made convertible into gold, and later declared inconvertible.

Bank Notes.—The several kinds of paper money that have been described up to this point are issued by the Treasury and are obligations of the United States government. Bank notes are also obligations of the government in the sense that their redemption in lawful money is guaranteed, but they are issued by national banks and Federal Reserve banks, and not by the government itself.

National bank notes are promises to pay to the bearer in "lawful money" the full face value of whatever notes a given bank puts into

tion reserves and is accumulating a reasonable surplus, and whether its operating and maintenance expenses are being increased or decreased under current business conditions—and only then are they ready to hand down a decision in a rate case. The commission makes no attempt to give the public utilities a particular percentage rate of return on the value of their properties, but tries merely to control rates so that the companies may pay dividends high enough to keep the value of their stock above par and permit the companies to market additional securities, when necessary, at not less than par. This plan seems to have much to recommend it, but its standing, in the light of past utility decisions of the Supreme Court, is uncertain.

The Success of Public Utility Regulation.—It was necessary for the state governments to delegate the regulation of public utilities to public utility commissions, for direct regulation by state legislatures would scarcely be feasible. But it must be admitted that commission regulation has not been entirely satisfactory. This may be accounted for in part by the fact that the commissions have been set to work solving problems for which there are no wholly satisfactory solutions. Some commissions have been given adequate powers and ample expert assistance, so that they have been able to operate successfully, but the reverse is true in many cases.

Many conditions among public utilities which the commissions were expected to remedy have continued to exist. They have often been unable to prevent utility companies from inflating or writing up the value of their assets, or from selling securities amounting to much more than the aggregate value of their assets. Indeed, it is probable that total overcapitalization in the public utility industry runs into billions of dollars. While the commissions have usually discounted to some extent the claims of public utilities with respect to the value of their properties, it is nevertheless true that the official valuations of these properties have often greatly exceeded the amount of the actual investment: A fair rate of return on an excessive valuation is equivalent, of course, to an excessive rate of return on a fair valuation.

Even if the valuation were perfect and the rate of return fair, the common stockholders of a utility company might still receive an unduly high return on their investment, because of the low fixed rates of return to holders of bonds and preferred stock. When the valuation is excessive, and the fair rate of return represents a very high return on total actual investment; the earnings of common stockholders on their investment may run to four or five times the nominal fair rate of return. It is true, also, that commissions have been unable to prevent excessive discrimination between different classes of customers. Of course, no one contends that all customers should be charged the same rates for (say) electricity, regardless of the amount of power used or the hours at which they use it; but electric companies have been known to sell a large part of their

circulation. They have been issued by national banks which have deposited with the Treasurer of the United States registered government bonds of specified issues up to 100 per cent of the note issue, and in addition a redemption fund of lawful money amounting to 5 per cent of the par value of the notes issued. National bank notes are redeemable in lawful money at the Treasury or at the bank that issued them. Since August 1, 1935, they have been disappearing from circulation. As of that date, the Secretary of the Treasury called in the government bonds on the basis of which national bank notes were issued, and thus made it unprofitable for the banks to keep the notes in circulation. Several hundred million dollars' worth have since been redeemed, and yet on August 1, 1941—six years after the retirement of the bonds by the Treasury became effective—national bank notes to the amount of 150 million dollars were still outstanding. Presumably, this form of paper money will become progressively scarcer, and eventually disappear entirely.

Federal Reserve bank notes differ slightly from national bank notes in their nature and conditions of issue. One difference lies in the fact that the note issues of Federal Reserve banks are not limited, as are those of national banks, to the amount of the issuing bank's capital. A second difference is that Federal Reserve bank notes may be issued not only on the basis of government bonds, but also with any direct obligations of the United States, or with approved commercial paper up to 90 per cent of its face value, as security. It was the intent of the Federal Reserve Act of 1913 that Federal Reserve bank notes should gradually replace national bank notes, the latter being retired from circulation. But this change has not taken place to any appreciable degree. The national bank notes are being replaced, rather, by Federal Reserve notes, which are issued on a different basis from Federal Reserve bank notes. At present, the total face value of Federal Reserve bank notes is about one-seventh of the total face value of national bank notes. Federal Reserve bank notes are redeemable in lawful money at the Treasury and at the Federal Reserve bank of issue.

Federal Reserve notes, despite their similarity in name to Federal Reserve bank notes, are issued on very different terms. They will be described in detail in a later chapter, but it may be mentioned here that prior to 1933 they were secured, up to 100 per cent of their issue, either by gold or by a combination of gold and commercial paper. In the latter case, it was required that at least 40 per cent of the total should be gold. Since the passage of the Emergency Banking Act in 1933, direct obligations of the United States may be substituted for eligible commercial paper if such substitution is approved by the Board of Governors of the Federal Reserve System, and gold certificates are now used as security in place of gold. Commercial paper, it should be added, consists of notes, drafts, and other paper obligations arising out of commercial transac-

organizations to supply service to farms, and to small communities which could not themselves support public utilities.

It would seem that, if there were no offsetting disadvantages, the holding company would be the fairy godmother of the public utility industry, transforming, as by a wave of the wand, inefficient, high-cost operating companies into efficient, low-cost enterprises, and furnishing managerial and other services, materials, supplies, and capital to the operating companies on most reasonable terms. Without the holding company, it might be argued, many of our public utilities would be unable to operate, or could continue in business only by charging higher rates than at present. Why should anyone want to destroy or regulate so useful an organization? But there is, unfortunately, another side to the picture.

The Pyramiding of Holding Companies.—If operating companies may enjoy these several benefits through the device of the holding company, it would seem that most of these advantages could be realized through the assistance rendered by a first-degree, or at most by a second-degree holding company. But our holding company systems have not stopped at the second degree. Many of them have at the top a holding company which is several times removed from the operating companies in its fields. According to a well-known writer on financial organization:

Out in Oregon, you find a little company called the Yawhill Electric Company. It belongs to the Portland General Electric Company. But the Portland Company belongs to the Pacific Northwest Public Service Company. This might be thought to be the parent organization. It controls the public utilities of Portland, the gas company in Seattle, and street railways and other utility companies in various towns. But this is not the end of the maze. The last-named company belongs to the Central Public Service Corporation, which owns other utility systems in Delaware, Maryland, and Virginia. And that in turn belongs to the Central Public Utility Corporation, which owns various other holding companies, with utilities and other sorts of enterprises from Maine to Oregon.

But this is still not the end. The Central Public Utility Corporation is held by a super-holding company called the Central Public Service Company. Why the little Yawhill Electric Company in Oregon, the Tri-City Gas Company in Alabama, the Bridgewater Electric Company in Maine, and the Lower St. Lawrence Power Company in the Province of Quebec, plus a maze of companies (including the Compagnie d'Éclairage Électrique in Haiti) in a dozen or more states, should all be huddled in this same holding company nest, no one can explain. And the interests which support these weird structures are powerful. Nothing short of action by the federal government, and plenary power in the agencies entrusted with the job, can clean up such situations.*

This should not be considered an exceptional case, for it is asserted that, in some public utility systems, the top holding company is ten to fourteen stages removed from the actual operating companies. As to geo-

* J. T. Flynn and P. H. Gadsden, "The Holding Company Bill," *Forum and Century*, May, 1935, pp. 259-265.

tions. These items also will be dealt with later. Federal Reserve notes are redeemable in lawful money at the Treasury or at any Federal Reserve bank. They comprise approximately 70 per cent of all United States money actually in circulation—that is, outside the Treasury and the Federal Reserve banks.

Convertibility of Paper Money.—We shall now examine several points of difference as between representative, convertible, and inconvertible money, with illustrations drawn chiefly from monetary experience in the United States.

Representative money is a receipt for, and promise to return upon demand, a specified amount of metallic money which has been intrusted to a responsible public authority, by whom it is to be held until called for. Thus, United States silver certificates are receipts for, and claims upon, silver that has been deposited with the Treasurer of the United States.

Silver certificates have frequently been classified as convertible money, and rightly so up to 1933, since, though they were *directly* redeemable only in silver, they were *indirectly* convertible into gold. Now that gold redemption of paper money has been suspended, it is no longer correct to say that silver certificates are convertible. Another characteristic of silver certificates is that they are backed, dollar for dollar, by the actual silver in which they are redeemable. Moreover, they are used purely as substitutes for metallic money, and not (like bank notes) as devices for increasing the amount of currency in circulation. As we have already observed, they have the advantage of being more convenient in handling than the metal, and their use prevents wear and tear on the coins themselves.

Prior to the recall of gold from circulation in 1933, gold certificates as well as silver certificates were representative money, since gold certificates were actually backed by and were redeemable in gold at the Treasury. They still have a dollar-for-dollar backing in gold, but the gold for which they call is no longer obtainable upon demand. Consequently, gold certificates do not now rate as representative money, but come under the heading of inconvertible paper money.

Convertible Paper Money.—The convertibility of paper money rests upon the maintenance of an adequate reserve which may be drawn upon if redemption is demanded, and upon legal provision that the money shall be redeemed upon demand to the proper authorities. All of the paper money in use in recent years in the United States was, up to 1933, convertible into gold, either directly or indirectly. But so ample were the reserves from which redemption could be made that there was seldom an extensive demand for standard money in exchange for paper; for, strangely enough, the redemption of paper money is seldom desired unless there is fear that redemption, if requested, will be refused.

Those in charge of the topmost holding company control the affairs of the subsidiary holding companies and the operating companies as well. They have the power to appoint, directly or indirectly, presidents and managers for the operating companies and determine their salaries. Often they have appointed themselves or their associates as officials of the subsidiary companies, at very choice salaries and occasionally with generous arrangements for pensions in their old age. Funds for these purposes came, of course, from the payments made by consumers for the services of the operating utility companies.

Moreover, the men in control of the highest holding company often owned other companies which sold machinery, equipment, materials, and supplies, of the types required by the operating companies, or sold construction and engineering services. Hence, they were able to sell the operating companies commodities and services at virtually whatever prices they chose to charge. If, for example, the manager of a small electric company needed (say) a new dynamo for his plant, he would submit the matter to the manager of a holding company in another place. The holding company manager would tell him whether he could have the money for the operating company, how much he could have, just what he should buy with it, from whom he should make the purchase, and what price he should pay. This would often result in the equipment being purchased from a company owned by the men at the top, and at a price which they themselves fixed. If this company charged the local operating company too much for the equipment, nobody but the insiders would be any the wiser.

In these and other ways, those in control of a holding company system could often find ways to line their pockets without sharing the income of subsidiary companies with other people. The practice of charging exorbitant prices to operating companies for machinery and equipment was important not only from the point of view of "milking" the operating companies, but also because the rates the operating companies were allowed to charge were usually determined by public utility commissions on the basis of permitting these companies to earn a fair rate of return on the cost of the property of the companies used and useful in the public service. Hence, the rates paid by consumers might be unduly high because of the high prices paid by operating companies for equipment. Finally, it will be recollected that a major claim for the holding company is that it makes it possible for the operating companies to obtain capital which they themselves might not have been able to attract. However, this process has sometimes been reversed and the operating companies have been compelled, to their detriment, to make "upstream loans" to their holding companies.

Propaganda and the Control of Legislation.—We must mention, also, as an evil related to holding companies, the extent to which these corpora-

It was this fear which, in the great depression following 1929, gave rise to such unprecedented demands for gold in place of paper money that the privilege of redemption in gold was withdrawn in 1933. The metallic backing of our paper money, while more than adequate to meet the demands of normal times, has never of course been sufficient to permit the redemption, in gold or silver, of all paper money outstanding. The payment of gold and silver certificates was fully assured by the maintenance of a 100 per cent deposit. Gold to the amount of 43 per cent was held as a reserve against the outstanding United States notes, or greenbacks. National bank notes and Federal Reserve bank notes had a monetary backing of only 5 per cent, which might or might not be gold. And the metallic security of Federal Reserve notes was usually only a 40 per cent deposit of gold. *In the final analysis, convertibility means redemption in gold if gold is demanded.* But we have never had a sufficient stock of gold to permit the redemption of all kinds of money which the government had promised to redeem in gold. It is apparent, therefore, that in the face of a growing demand for redemption the only way to prevent a collapse of the monetary system was to withdraw, at least temporarily, the privilege of converting paper money into gold, the standard money of the United States.

Inconvertible Paper Money.—Inconvertible paper money is currency which has no value in itself and is not redeemable in standard coin, but circulates only by authority of government. According to one well-known writer, inconvertible money is used "because the people have no better money, and the quantity is so limited that its evils do not yet appear, or because the government is strong enough to compel its citizens to accept the paper."² Inconvertible money (or "fiat money," as it is often called) is usually made legal tender; this fact and the confidence that people have in the promises of their government are sufficient explanation of the acceptability of a money that cannot be redeemed in coin or bullion.

Fiat money is most often issued in time of great emergency, such as war, when the printing of money appears to be the easiest way (and sometimes, indeed, the only way) to secure funds with which to meet necessary expenses. The Civil War was responsible for the issuance of greenbacks, and the first World War brought upon European countries a veritable deluge of fiat money. Inconvertible money sometimes becomes convertible, as was the case with the greenbacks after an interval of seventeen years. But Russia, Germany, and Austria printed paper money in such tremendous quantities in order to meet war and post-war needs, that redemption was out of the question and the notes were repudiated. France, facing a problem that was similar but not so serious, chose to "stabilize" the franc at a fraction of its former gold

² David Kinley, *Money*, New York, The Macmillan Company, 1904, p. 332.

that are constructed are equipped to produce electric power, which may be marketed in competition with the electricity sold by the private utility companies. In the fiscal year 1939, total sales of electricity by the T.V.A. amounted to 1,618,286,752 kilowatt-hours, with a total revenue of \$5,445,198, or 3.36 mills per kilowatt-hour.¹¹ It is frequently contended that the primary purpose of the T.V.A. is to produce and sell electric power. According to T.V.A. authorities, however, this is but one purpose among many. Other interests are flood control, the improvement of navigation, the production of fertilizer and explosives, and the rehabilitation of agriculture.

The dams permit flood waters to be stored up in great lakes, and it is said that they have already prevented millions of dollars' worth of damage along the Ohio and Mississippi Rivers. The T.V.A. expects to have a nine-foot waterway opened all the way from the Ohio River to Knoxville, Tennessee, to provide low-cost transportation for freight, and to aid the farmers of the area in preventing soil erosion and improving agricultural conditions generally. In so far as electric power is produced, it is held that the T.V.A. power plants are to be used as "yardsticks," to determine how cheaply electric power can be produced and transmitted, and in this way to find out whether existing rates in the district are fair and reasonable. It is also suggested that, if the private companies have to lower their rates for electricity because of T.V.A. activities, consumption will probably be increased so greatly that these companies will make larger net profits than in the past.

Criticisms of the T.V.A.—The critics of the T.V.A. assert that the project is designed almost solely for the production and sale of electricity in competition with the output of private companies. They point out that the T.V.A. has erected thousands of miles of transmission lines, and that it serves scores of communities and tens of thousands of industrial consumers. They point out, further, that the electric plants of the T.V.A., when completed, will produce about half as much power as is now sold in the seven states affected by the project, and that the T.V.A. has acquired more than \$110,000,000 worth of electrical facilities from private companies.¹² Citing these facts and reports that other projects similar to the T.V.A. are to be started, the critics conclude that the private electrical industry is to be destroyed, and government ownership substituted.

In allocating the costs of the total project among the three objectives—flood control, navigation, and power production—the T.V.A. decided that \$279,488,335 out of the total of \$505,340,021¹³ should be charged against power facilities. But critics contend that this is an underestimate of the cost of these facilities, and that the dams could have been built for far less if they had not been designed for the production of electric power. To allocate too little to the construction of power facilities would be, of

¹¹ *Ibid.*, p. 676.

¹² *Ibid.*, p. 696.

¹³ *Ibid.*, pp. 683-685.

value. But this, in effect, was repudiation of a large part of the obligation represented by the paper money outstanding.

A serious difficulty with fiat money is the grave likelihood of overissue, once the practice of printing this kind of money is resorted to. And when sufficient fiat money has been issued to serve as exchange media for all business transactions, fiat money alone will be used. Since it is customary to endow such money with the power of legal tender, it will theoretically circulate on a par with gold. But gold may be "called in" by the government. And even if it is allowed to remain in circulation, gold will not, in actual practice, be employed at all if an abundance of inconvertible paper money is available. On the contrary, as we shall see shortly in our examination of Gresham's Law, it will disappear from circulation, part of it being used in foreign trade, where its purchasing power is greater than at home; part being made into articles of utility or ornament; and part being stored away against the time when it can again be used to advantage in domestic trade.

Since 1933, the paper money of the United States has been inconvertible paper money, for in that year it ceased to be redeemable in gold, our standard money. The fact that silver certificates may be redeemed in silver dollars does not alter the situation, for the terms "convertibility" and "inconvertibility" relate only to standard money, and silver dollars do not qualify as standard money since their value as money is much greater than their value as bullion.

"Total Money" and "Money in Circulation."—Some kinds of money circulate freely, while other kinds do not. The total amount of money of the United States, on July 31, 1941, was distributed as follows:

Money held in the Treasury.....	\$19,835,272,285 ³
Money held by Federal Reserve banks and agents.....	3,465,142,100
Money in circulation.....	<u>9,732,083,411</u>
Total money in the United States.....	\$33,032,497,796

These figures make it clear that only about 30 per cent of the money of the United States is being used *directly* in carrying on business transactions. But this does not mean that the rest of the money is idle. Gold and gold certificates, when held in a Federal Reserve bank, permit the issuance of far more purchasing power (in the form of Federal Reserve notes or bank credit) than if they were used directly for buying goods. By using much of our money as *reserves*, instead of keeping all of it in actual circulation, we are enabled to increase enormously the funds available for conducting economic operations, as we shall see in the next chapter.

³ To avoid duplication, we have reduced this figure for gold and silver bullion actually held in the Treasury, deducting an amount equal to the total of gold and silver certificates *outside* the Treasury. Obviously, we should be guilty of double-counting if we included both the bullion and the certificates.

panies, the board of trustees could elect the officers of these companies and control them as a unit with respect to production and prices. The board would collect dividends on the securities held in trust, and distribute them among the owners of the trust certificates. The Standard Oil Trust, first organized in 1879, was an outstanding example of the use of the trustee device. This method of organization was attacked in the courts of several states and was declared illegal, both as tending to create monopolies and as an unauthorized activity on the part of the individual corporations.

The Extent of Early Monopolies.—Regardless of types of organization, monopolies of one kind or another controlled some 40 per cent of all manufacturing capital in the United States in 1904. Many of these monopolies were incomplete, some did not last long, and others turned out disastrously from the financial point of view; but in 1904 there were 26 monopolies which controlled 80 per cent or more of the production in their respective fields. The products affected ranged all the way from asphalt, bathtubs, and bicycles, at one end of the alphabet, to tin cans, window glass, and whiskey, at the other. Moreover, there were at least 8 concerns which controlled 90 per cent or more of the production of some or all of the articles which they produced.¹ These companies were the American Can Company, the American Sugar Refining Company, the American Tobacco Company, the Corn Products Refining Company, the International Harvester Company, the National Cash Register Company, the Standard Oil Company, and the United Shoe Machinery Company. Most of these companies were able to make extremely large earnings on their investments.

Modern Monopolies.—Many cases of complete, or almost complete, control of industries by single companies exist at the present time. It is said that "today one company in each field controls all, or nearly all, of the nation's supply of aluminum, nickel, molybdenum, magnesium, shoe machinery, glass container machinery, and scientific precision glass, provides nearly all of the domestic telephone service . . . and operates all of the sleeping and parlor cars."² The companies involved are the Aluminum Company of America, the International Nickel Company, the Climax Molybdenum Company, the Dow Chemical Company, the United Shoe Machinery Company, the Hartford-Empire Company, the Bausch and Lomb Optical Company, the American Telephone and Telegraph Company, and the Pullman Company.

In other cases, "pairs" of firms control all or nearly all of the supply of certain economic goods. Examples are the Western Union Telegraph Company and Postal Telegraph, Inc., in the domestic telegraph service;

¹ Temporary National Economic Committee Monograph No. 21, *Competition and Monopoly in American Industry*, Washington, Government Printing Office, 1940, p. 65.

² *Ibid.*, p. 69.

THE NATURE OF MONEY

With this picture of the kinds of United States money as a background, we proceed to a consideration of the character of money and its use in present-day economic life.

Attributes of a Satisfactory Money.—Money may be defined as *anything that serves as a standard of values, or is generally acceptable and is used primarily as a medium of exchange*. The traditional definition of money—"anything that serves both as a standard of values and a medium of exchange"—has not applied to United States money since April 5, 1933. For gold has not been allowed to circulate in this country since that date, and is therefore no longer a medium of exchange, though it still serves as a nominal standard of values. Hence, we have modified the traditional definition of money to meet the needs of the American situation. Gold still qualifies as money because it serves as a standard of values; and other kinds of money fall within the limits of the definition because they are generally acceptable and are used primarily as a medium of exchange. *Acceptability* is the prime essential of a good money, and this quality depends, in turn, upon a number of other attributes, namely, portability, durability, uniformity, divisibility, cognizability, and stability of value.

Many commodities have been used as money in the past, but have been discarded for this purpose because they failed to possess one or more of these attributes. Tobacco, which was quite generally used as money in colonial Virginia, was too bulky and heavy to be readily portable; and it also lacked stability of value, for its purchasing power depended upon the size of the total crop, and this varied greatly from year to year. Cattle and sheep, though used by pastoral tribes, are not easily divisible, nor are they at all uniform. They could not, therefore, be used in small transactions, and values could not be expressed accurately in terms of these animals because of differences in size, weight, and quality. Corn and wheat have served as money at times, but are unsuitable for several reasons, one being the absence of durability, since grains are subject to deterioration. Precious stones also have been used, but they are deficient in cognizability; that is to say, it requires an expert to tell whether they are genuine or spurious.

The influence of these attributes upon the acceptability of money should be fairly obvious. If a commodity is easily carried about (portability), if it gives promise of lasting for a long time (durability), if a unit is like every other similar unit in value (uniformity), if the standard unit is separable into smaller units for use in minor transactions (divisibility), if every unit is marked so that its genuineness and value are apparent to the average person (cognizability), and if its purchasing power does not fluctuate greatly from time to time (stability of value), then—but

existence of holding companies, this device is not automatically illegal, as was the old trustee device.

Mergers.—The merger is somewhat similar to the holding company. While the holding company controls several business firms through security ownership, the merger exercises the same control through holding the physical properties of the various firms. In some instances, several corporations lose their identity in a new corporation which is organized to manage all the properties of the old firms. In other cases, one of the old corporations remains in existence and the others are merged in it. Like the holding companies, mergers are not illegal in and of themselves. The existence of one or more holding companies or mergers in a particular industry does not necessarily mean a condition of effective monopoly.

Price Leadership.—Price leadership is an informal method of control. In industries in which the firms have heavy fixed costs, price-cutting is an extremely dangerous practice, especially if consumers can readily postpone their purchases. Each of the large companies knows that a price cut on its part would be swiftly followed by similar cuts by other large competitors, to the detriment of all companies concerned—and so prices tend to be maintained by the large companies, with some one company serving as the price leader. The numerous small companies which may exist in the same industry usually follow faithfully the price leadership of the large company or companies, either because they fear reprisals if they cut prices or because they believe their economic welfare will be enhanced by following the leader. In such industries, price changes seldom occur, and when they do occur are introduced by all firms at about the same time. Evidences of price leadership have been found in industries producing anthracite coal, packer cans, corn products, fertilizer, canned salmon, industrial alcohol, steel, cement, agricultural implements, gasoline, non-ferrous metals, newsprint paper, glass containers, and biscuits and crackers.⁵ Since price leadership involves no actual agreement or conspiracy among the firms, it is very difficult to combat.

Price Agreements.—When the sellers in an industry are relatively few they may enter into actual agreements to establish and maintain uniform prices and terms of sale. Price maintenance may also result from the activities of trade associations, but we refer here to price agreements between firms which are otherwise unassociated in their respective industries. Agreements of this kind are in open violation of anti-trust laws which forbid conspiracies in restraint of trade. During the past twenty years many court decisions have been handed down against firms maintaining price agreements.

Basing-point Systems.—In some industries a system of "delivered prices" is maintained through the use of one or more "basing points." When several basing points are used, all firms in a given district charge their cus-

⁵ *Ibid.*, p. 123.

not until then—does it become “generally acceptable” and meet the needs of a satisfactory medium of exchange.

Gold, Silver, and Paper Money.—Because the articles that we have mentioned above, and many others that have been used in the past, are deficient in the qualities required of a satisfactory money, their place has been taken in most important countries by gold and silver, and by paper based upon these two precious metals. Gold and silver possess, to a high degree, the characteristics which are desirable in money. Of the two, gold has an advantage over silver because of its higher value in relation to bulk and weight.

Gold, combining high value with slight bulk, satisfies the requirements of portability. It does not deteriorate with the passage of time, nor does it wear away rapidly through handling if it is hardened by the addition of an alloy. It presents no difficulties so far as uniformity is concerned. Though gold is readily divisible, its great value per unit of weight makes it unsuitable for small coins, so that silver, copper, and other metals are commonly used for making units of small denominations. When coined by a responsible government, gold is generally recognizable. It varies considerably in value from time to time, but is more stable than most commodities. Silver possesses these same qualities, though most of them to a lesser degree than gold; and one or the other of these two metals forms the nominal basis of every important monetary system of modern times.

The Question of Acceptability.—Our definition includes paper money as well as metallic money, if only it is generally acceptable. Paper currency is very extensively used, and passes from hand to hand as freely as gold and silver, whenever there is confidence on the part of the receiver that he will experience no difficulty in passing it on to someone else, at full face value, in exchange for economic goods. But checks, drafts, and certain other negotiable papers do not fall within the definition, largely because they lack cognizability. A check signed by Henry Ford, for example, would not be *generally* acceptable because the average person could not be certain that the signature was genuine and not a forgery. In like manner, a personal note (or “promise to pay”) is not money, since many persons would decline to accept it on the ground that it might not be paid when due.

Legal Tender and Lawful Money.—Legal tender is money which by legal declaration must be accepted by a creditor in payment of debt, in the absence of an agreement to the contrary. The power of legal tender is conferred upon certain specified forms of money for the purpose of facilitating the settlement of obligations. A refusal to accept legal tender in settlement of an obligation does not mean that the debt is canceled, but simply that the debtor need not pay interest accruing after the date on which payment in legal tender was proffered. The

these, 59 were active in the affairs of at least one of the corporations which they served.¹⁸

The National Resources Committee found that companies controlling 62 per cent of the total assets of the 200 largest non-financial and 50 largest financial groups were members of 8 large "interest groups," which combined industrials, railroads, and public utilities with financial organizations in informal communities of interest. The so-called Morgan-First National interest group included 13 industrials, 12 public utilities, 5 major railroad systems, and 5 banks. These companies had total assets of over \$30,000,000,000. The Kuhn Loeb group included 5 major railroad systems, 2 other railroads, 1 utility, and 1 bank, with total assets of almost \$11,000,000,000. The smallest of the 8 interest groups was the Boston group, which comprised 4 industrials, 2 utilities, and 1 bank, with total assets of less than \$2,000,000,000.¹⁹ There was also said to be much overlapping and interconnection between these interest groups.

Controlling the Government.—That the large business and financial interests of the country are organized into pressure groups, for the purpose of influencing and controlling our various governmental units, seems hardly open to question. According to a recent government study, these pressure groups include such organizations as the Chamber of Commerce of the United States, the National Association of Manufacturers, the Edison Electric Institute, the Association of Life Insurance Presidents, the Association of American Railroads, the American Bankers Association, the Investment Bankers Association of America, the American Iron and Steel Institute, the American Petroleum Institute, the National Lumber Manufacturers' Association, the National Coal Association, the Copper Institute, and such closely related groups as the American Bar Association and the American Newspaper Publishers Association.²⁰ There are, of course, other pressure organizations representing workers, farmers, and other groups, but in general the forces of business and finance are better organized and have far greater resources and staying power.

The methods used by pressure groups in attempting to influence the government include working for "favorable" candidates for legislative and other offices, and against other candidates; lobbying for the passage of desired legislation and to prevent the passage of unfavorable laws; opposing the administrative agencies charged with the duty of enforcing laws affecting business and finance; fighting unfavorable laws through the courts and advising members to disregard the laws until court decisions have been reached; trying, in later elections, to bring about the

¹⁸ Temporary National Economic Committee, *Progress Report of the Executive Secretary, January 15, 1941*, p. 11.

¹⁹ National Resources Committee, *The Structure of the American Economy*, pp. 306-317.

²⁰ Temporary National Economic Committee, Monograph No. 28, *Economic Power and Political Pressures*, Washington, Government Printing Office, 1941, pp. 14, 15.

power of legal tender adds to the acceptability of money, since the person receiving it knows that it can be passed on to others in payment of obligations outstanding.

Prior to 1933, the question of legal tender in the United States was a complicated one, for some forms of American money enjoyed full legal tender whereas others were legal tender only for certain purposes or in limited quantities. In actual practice, however, there has been no real difficulty, since every form of our currency has been readily convertible into any other form that might be desired. But even the academic perplexities of the situation have now been cleared away, for by joint resolution of Congress on May 26, 1933, "all coins and currencies of the United States (including Federal Reserve notes and circulating notes of Federal Reserve banks and national banking associations) heretofore or hereafter coined or issued" were declared full legal tender for all debts, public and private.

The term "lawful money" is one which we have used in the present chapter, and which is in common use in monetary discussion. It is a term which requires no explanation other than the statement that lawful money is synonymous with legal tender, in so far as United States money is concerned. The two terms may therefore be used interchangeably.

Coinage.—The coinage of metallic money and the printing or engraving of paper currency are almost invariably carried on either as a government monopoly or under strict governmental control. This, again, is an arrangement that contributes definitely to the acceptability of money, since it guarantees the use of metals of uniform fineness, units of standard weight, and therefore coins which will be received without hesitancy by the general populace. Coins of a given value are of uniform appearance and are easily recognized. They are struck from excellent dies in such manner as to render counterfeiting difficult. Not only are they stamped on both sides, but the edges of the more valuable coins are usually sharply "milled," as a precautionary measure against impairment of metal content by shaving or clipping. In the manufacture of paper money, fraud is discouraged by the use of special paper on which are printed or engraved intricate designs that cannot easily be reproduced by private individuals.

Policies of coinage differ with different countries. Occasionally a government aims to make a profit on the manufacture of money by charging more than enough to cover the costs of coinage; this is known as *seigniorage*. More often a charge known as *brassage* is made, this being an amount just sufficient to cover the costs involved. Or the system may be, as it was in the United States until 1933, one of *gratuitous coinage* of the standard metal. For in this country the holder of gold bullion could take it to the government mint, and there have it made into coin without charge except for the alloy which was mixed with the pure

rather brief, though important, document. It declared illegal all contracts, combinations of business firms, and conspiracies, in restraint of interstate or foreign commerce. It made guilty of a misdemeanor every person who monopolized, attempted to monopolize, or combined or conspired with any other person or persons to monopolize, any part of the trade or commerce among the states or with foreign nations. It declared illegal all contracts, combinations, and conspiracies in restraint of trade in a territory of the United States, in the District of Columbia, or between either of these and any state, states, or foreign nations. The term "person" as used in the Act was defined as including corporations and associations.

Penalties for the violation of these provisions were set at a fine not exceeding five thousand dollars, or imprisonment not exceeding one year, or both. Persons suffering damages as the result of violations of the Act could sue the guilty parties in the federal courts and recover triple damages, plus costs. The circuit courts of the United States were given authority to prevent and restrain violations, by injunction or otherwise, upon petition of the district attorneys and after hearings had been held. These courts were empowered to summon witnesses from any part of the country. The property of any violator, intercepted in the course of interstate or foreign commerce, was declared forfeited to the United States.

Enforcement of the Sherman Act.—At first glance it would seem that Congress, in passing the Sherman Act, had forged a powerful weapon for dealing with monopolies. However, the Sherman Act was quite ineffectual for many years, and the period of most active monopoly formation—1897 to 1903—occurred after its enactment. This early ineffectiveness of the Act was attributable to several causes, including uncertainty of the exact meaning of certain parts of the law, lack of funds with which to enforce it, the apathy and incompetence of the attorney-generals and their subordinates which led to poorly drawn indictments and inexperienced pleading of cases, and the lack of public support. In 1895, an important case involving the sugar trust, *United States vs. E. C. Knight Company*, was decided in favor of the trust in such manner as to throw doubt upon the federal government's power to deal with monopolies. The Supreme Court held that the government had proved only the concentration of industrial control in the industry and not restraint of interstate or foreign commerce.

A few years later, two decisions favorable to the government put new life into the Sherman Act. In 1899, the Supreme Court unanimously upheld the decision of the Circuit Court of Appeals dissolving the pool between the Addyston Pipe and Steel Company and five other corporations, all engaged in the manufacture of cast-iron pipe, and enjoining the pool members perpetually from carrying out their agreement. In 1904, the *Northern Securities Company* case decided definitely that the Sherman

gold to give it the proper degree of hardness. Moreover, he was able to have it coined in *unlimited quantities*. This latter feature is known as the "free coinage" of gold.

But gold coin is no longer a part of our monetary system, and so we have no coinage of our standard metal. Gold may now be monetized only through its purchase by the Treasury, the seller receiving not gold coin, as was his privilege in the past, but some form of paper money in exchange for the bullion. Silver has not for many decades been "freely" coined in this country; that is, it has not been coined (as was gold prior to 1933) upon the simple request of the holder of bullion. When there has been need for more silver coins, they have been stamped from silver bullion purchased by the government for that purpose.

THE FUNCTIONS OF MONEY

Medium of Exchange.—The primary function of money, as was indicated in our definition, is to act as a medium of exchange. When an economic society gets beyond the stage of barter, in which producers trade their surplus goods directly for goods of various kinds produced in surplus by others, the need for a satisfactory medium of exchange is apparent. Money, because it possesses the several attributes we have enumerated, is such a medium. Being easily exchangeable for commodities which one wishes to secure, it is readily accepted in return for goods that one may hold in excess and may therefore wish to sell. Exchange is greatly facilitated through the agency of money, for its use permits the employment of middlemen, who, though not desiring to consume certain goods themselves, are yet willing to purchase them (giving money in return) and later sell them (receiving money in return). In this manner, a producer is enabled, indirectly but conveniently, to deliver his product to the consumer. Through the instrumentality of money, moreover, services may be exchanged just as readily as material goods.

We have already noted the fact that gold has ceased to function in the United States as a medium of exchange. The monetary gold stock of this country is held in the United States Treasury, and paper money is circulated in its stead. An arrangement of this kind is satisfactory as long as public confidence in the paper money can be sustained, and this is largely a matter of keeping the amount of money issued down to a quantity that will not raise general prices unduly. But the acceptability of paper money does not ordinarily extend beyond the boundaries of the country of issue. Consequently, the settlement of balances arising through international trade (a subject which will be treated in a later chapter) is made in gold on the basis of weight.

Standard of Values.—Money serves also as a standard of values, which is merely another way of saying that it provides us with a common denominator in terms of which all other commodities may be expressed and

contracts. Because of the popularity of the holding company device, the Act specifically provided that holding companies were illegal if their effect was to lessen competition substantially in any industry, to restrain commerce in any section or community, or to create a monopoly in any line of commerce. It was also provided that, after 1916, no person should be at the same time a director of two or more corporations engaged in commerce, other than banks and common carriers, any one of which had a capital, surplus, and undivided profits of more than \$1,000,000, if such corporations were, or had been, competitors, so that the elimination, by agreement, of competition between the firms would constitute a violation of the anti-trust laws.

Violations of the anti-trust laws by corporations were thereafter to be considered as violations by the directors or other officers who were responsible for the illegal activities, and these officials were to be subject to the penal provisions of the anti-trust laws. Labor organizations and certain types of agricultural associations were exempted from the provisions of the anti-trust laws. Responsibility for the enforcement of these laws was vested in the Federal Trade Commission for industrial combinations, the Federal Reserve Board for financial institutions, and the Interstate Commerce Commission for combinations in transportation. The Clayton Act constituted an addition to, rather than a change in, the anti-trust law as set up in the Sherman Act, for government suits against monopolies continued to be brought under the Sherman Act. The Clayton Act was also intended to be a preventive measure in connection with monopoly formation rather than, as in the case of the Sherman Act, a cure for monopolies after they had been formed.

The Federal Trade Commission Act.—A commission of five members, appointed by the President, for the administrative regulation of business conduct was created by the Federal Trade Commission Act, which like the Clayton Act was passed in 1914. The principal powers of the Federal Trade Commission were (1) the investigation, and (2) the prevention, of unfair competition.

In the field of investigation, the Commission was empowered to gather and compile information concerning the organization, business conduct, practices, and management of any corporation engaged in commerce, except banks and common carriers, and to require such corporations to make regular or special reports, or to answer specific questions. It could, upon request of the President or either house of Congress, investigate and report the facts concerning alleged violations of the anti-trust acts by any corporation. When requested by the Attorney-General, it could investigate and make recommendations for the readjustment of the business of any corporation alleged to be violating the anti-trust laws, and, when requested by the court, could ascertain and report an appropriate form of decree in any suit in equity under the anti-trust laws, and in-

their importance in exchange easily compared. The convenience of reducing all commodities and services to this common unit is very great. If a garden hoe exchanges for two pounds of butter, it is possible, of course, to express the value of hoes in terms of butter and the value of butter in terms of hoes. But it is more convenient to express both in terms of dollars, saying, for example, that a hoe is worth a dollar and a pound of butter is worth fifty cents. Once the standard is well established and universally understood, values are automatically reduced to its terms. Thus the statement that hoes are selling at one dollar each, and butter at fifty cents (or a half-dollar) a pound, is instantly and completely comprehensible to any person accustomed to our monetary system. The use of a standard unit (such as the dollar) makes it easy to compare the values of goods to be bought and sold.

Because money functions as a standard of values, it does not follow that it possesses stability of value. Indeed, we have already noted its deficiency in this respect; but this is a shortcoming in which all commodities share, and some to a far greater degree than gold. Money is not, then, an unvarying standard of measurement such as the pound, foot, and bushel (which remain constant from year to year), but simply, as we have said, a common denominator in terms of which one may conveniently compare the values of different articles at a given time.

However, the establishment of a monetary standard, such as the dollar, does fix definitely the relative values of the several kinds of money included in the system. A fifty-cent piece, for instance, is always a half-dollar, even though its value as bullion is less than that of $7 \frac{13}{21}$ grains of gold nine-tenths fine. And two halfdollars will continue to have as great purchasing power as a paper dollar of any issue, a silver dollar, or one hundred cents' worth of subsidiary coin of any kind, as long as each of the several forms of money in circulation is readily exchangeable for any other form, and all forms have the power of full legal tender.

Standard of Deferred Payments.—Present-day exchange consists largely of giving commodities or services, not in return for other commodities or services, or even for money, but in return for promises to pay at some future date. It is estimated that more than 90 per cent of the business of the United States is conducted on the basis of credit. But when a credit transaction takes place, some definite provision is usually made for settlement in the future and money is called upon to act as the standard of these deferred payments.

This means that an agreement is made to meet the obligation, at a specified future date, by paying in money the amount due. It is here that stability in value of money is especially desirable, since it is important that the amount of purchasing power delivered to the creditor when the obligation falls due should be the amount which, when the

if the Federal Trade Commission had never been set up. Many monopolistic organizations have probably modified their business practices in view of the powers granted the Commission for the control of unfair methods. Since unfair practices often gave monopolies their start or at least were of considerable aid during their formative period, it is probable that the organization of some monopolies has been prevented by the work of the Commission. Though the Commission has been hampered at times by the restrictive decisions of the Supreme Court, and by the tendency of that Court to perform all over again work which had already been done by, and was the proper function of, the Federal Trade Commission, it is generally conceded that the Commission has acquitted itself creditably.

The Federal Trade Commission has also been able to accomplish much in the way of eliminating unfair competition through voluntary cooperation on the part of business men. It has encouraged trade practice conferences, with the representatives of an industry assembling, either on their own initiative or at the request of the Commission, but in either case under the auspices of the Commission, to discuss fair and unfair practices in the industry and provide for the elimination of the unfair methods with the cooperation and support of the Commission. This method has the advantage of dealing with a whole industry at one time, and permits business men to appear as friends of the Commission rather than as accused persons. The conference method has grown so rapidly in favor that in 1926 the Commission found it necessary to set up a Division of Trade Practice Conferences to expedite this work.

Minor Changes in the Anti-trust Laws.—During the period from 1914 to 1929, several minor changes were made in the application of the anti-trust laws. The Shipping Act of 1916 legalized agreements between steamship lines with regard to fixing rates, apportioning traffic, and other matters, subject to the approval of the Shipping Board. The Packers and Stockyards Act of 1921 classified packers, commission merchants, and stockyards for special regulation under the supervision of the Secretary of Agriculture. The Webb-Pomerene Act of 1918 legalized agreements and associations entered into for the sole purpose of engaging in export trade, or holding company arrangements for the same purpose, providing that restraint of trade within the United States did not result. The Capper-Volstead Act of 1922 legalized the organization of cooperative associations of agricultural producers, provided they operated for the mutual benefit of members, did not handle products of non-members to an amount greater in value than those handled for members, and either allowed no member more than one vote or paid no dividends on stock or membership capital in excess of 8 per cent a year.

The N.R.A. and the Anti-trust Laws.—As the post-1929 depression wore on, an increasing volume of opposition to anti-trust laws developed among business men. It was held that business instability was bound to

transaction took place, the debtor promised to deliver. Our study of price levels in a later chapter will show that, because money itself fluctuates in value, the purchasing power delivered on a deferred payment may be either greater or less than was implied in the contract, depending upon whether money has increased or decreased in value in the meantime. The fact remains, however, that money is the standard generally used; and it will continue to perform this function until the business world has been convinced of the advantages of one or other of several new standards that have been proposed for the purpose.

Basis of Credit.—It is difficult to grasp the significance of money as a basis of credit without understanding the fundamentals of our system of banking, which will be described in Chapters 33 and 34. It may be said, however, that the adoption of a standard money, and its use as a reserve, permit the safe circulation of a volume of paper substitutes vastly greater than the original amount of standard money. We shall see that for every dollar's worth of gold certificates deposited as security with a Federal Reserve bank, there is the theoretical possibility of expanding credit to the extent of \$28.50. This element of elasticity is one which was not fully appreciated in this country prior to the adoption of our Federal Reserve System in 1914. It means, however, that as business expands, the volume of credit increases to meet its requirements, decreasing again when so much credit is no longer needed.

MONETARY SYSTEMS

Standard Money.—Standard money, in the strict sense of the term, is money that contains the amount of metal necessary to make its value as bullion exactly equal to its value as money. If a country used nothing but standard money, there would never be any question about its acceptability so long as the standard metal was desired on its own account. For the coin could be converted into bullion by the simple process of melting, and the bullion, in turn, could be turned readily into money if a system of free coinage were in effect.

Measured by the above definition, gold bullion constitutes the only strictly standard money in this country. Silver dollars, though they were once standard and are still called by that name, are greatly underweight, and so also are all subsidiary coins. Paper money, despite its value in exchange, possesses almost no value as a commodity. The gold certificate, even though it is virtually a receipt for gold that is actually held in the Treasury, is at present inconvertible, and thus is as remote from being standard money as are the other kinds of paper money. Forms of United States money, other than gold bullion, may be called "credit money" since they represent promises to pay. This statement applies to short-weight metallic money (which includes all metallic money now in circulation) as well as to paper money.

that the N.R.A. gave a strong impetus to the growth of monopoly powers in many industries and interfered seriously with the traditional governmental policy toward monopolies.

The Robinson-Patman Amendment.—Several other recent laws have a bearing on the monopoly problem in the United States. One is the Robinson-Patman Amendment to the Clayton Act, passed in 1936. The prohibition of price discrimination by the Clayton Act was concerned chiefly with the effects of such discrimination upon the competitors of the offending company. But price discrimination may have important effects upon the different buyers and their customers, and the Robinson-Patman Amendment seeks to broaden and clarify the provisions of the Clayton Act on this point.

The amendment forbids sellers to charge different prices to different purchasers of commodities of like grade and quality—unless such price differences make only due allowance for differences in the cost of manufacture, sale, or delivery—whenever such discrimination would lessen competition substantially (1) between any buyer and the discriminating firm, (2) between the less favored and the more favored buyers, or (3) between the customers of those buyers. In the past, it was common for manufacturers to market part of their products at regular prices, and to sell the remainder to mail-order houses, chain stores, or department stores at low prices for sale under a different name; or to discriminate for or against these types of marketing agencies, as compared with ordinary wholesalers, jobbers, and retailers. Any such discriminations, unless they can be justified on the basis of cost, are forbidden under the Robinson-Patman Amendment.

Moreover, the amendment authorizes the Federal Trade Commission to fix and establish certain quantity limits beyond which price differences may be prohibited, even though these differences are justified on the basis of differences in the cost of manufacture, sale, or delivery. It is clear that such provisions tend to handicap distributors who have formerly purchased in large quantities and sold at low prices. The amendment itself applies only to sellers in interstate commerce, but it has been reinforced by 32 state laws with similar provisions.

The Miller-Tydings Act.—The Sherman Act of 1890 was amended by the Miller-Tydings Act of 1937, so as to legalize contracts for the maintenance of resale prices of branded articles wherever such contracts are approved by state laws, as they are in all but four states. Price-cutting on branded articles, and especially their use as "loss-leaders" by chain and department stores, had long been a source of annoyance, both to manufacturers of the goods, who tried by extensive advertising to build up good will for their goods at regular retail prices, and to competing independent merchants who naturally found their own trade injured by such price-cutting. Under the Miller-Tydings Act, the prices of branded

Monometallism.—For many years prior to 1933, the monetary standard of the United States was monometallic. Gold was the basis of our monetary system, and we were said to have a “gold standard.” The standard unit was the gold dollar, which was 25.8 grains of gold nine-tenths fine; there was free coinage of this metal; there was no prohibition on melting or exporting gold coin; the gold dollar was full legal tender; and all other kinds of United States money were convertible, directly or indirectly, into gold coin.

We shall later describe the system that obtains in this country at the present time. The characteristics listed above are those which marked the monetary system of the United States while it was on a monometallic gold standard. Until quite recently monometallism has been a world-wide phenomenon, and in most countries of economic importance the standard metal has been gold.

Bimetallism.—But most governments, before adopting monometallism, have had some experience with a bimetallic standard. Under bimetallism, two metals—usually gold and silver—are coined upon presentation at the mint and in unlimited quantities, and both are full legal tender. As in the case of monometallism, there is no prohibition of melting or exportation. In setting up a system of bimetallism, it is necessary to decide upon a *mint ratio* to express the relative values of the two metals when used as money. The ratio adopted is naturally one that conforms very closely to the *market ratio*, which expresses the terms on which the metals exchange as bullion. If one ounce of gold, as metal, commands sixteen ounces of silver bullion in exchange, the market ratio is 16 to 1, and the same figures would ordinarily be chosen at the outset for the mint ratio.

So far, so good. And if the market ratio remained constant indefinitely, or the mint ratio could be manipulated so as to duplicate changes in market value, all would be well. But the market values of gold and silver, as of all commodities, depend upon the general conditions of supply and demand. Since both are constantly being mined, but in varying quantities, and since the demand for the metals is likewise subject to variation, their market values are constantly changing. In the year 1500 the market price of gold was about eleven times that of silver, so that the market ratio between silver and gold was 11 to 1; in 1850 it was about 15½ to 1; in 1900, 34 to 1;⁴ and in 1940, approximately 100 to 1. This 1940 ratio of 100 to 1 was arrived at, of course, by comparing the prices per ounce of gold and silver, and these prices were, respectively, \$35 and 35 cents.⁵ The market ratio, then, lacks stability. Nor is it feasible to

⁴ Cf. W. H. Steiner, *Money and Banking*, New York, Henry Holt & Company, Inc., 1933, p. 81.

⁵ Under presidential decree of April 24, 1935, the price of silver eligible for Treasury purchase, consisting of *newly mined American silver*, was made 77.57 cents an

amounted to very little. It has been practically impossible to send men to jail for monopoly activities, and the financial penalties have been too small to be effective. The granting of triple damages to those who have suffered from monopoly activities has never constituted a serious embarrassment to the monopolies. Some monopolies have been able to avoid prosecution altogether, while others have been brought into court only to escape all penalties for their activities.

When the government has prosecuted anti-trust cases successfully, and the courts have ordered the dissolution of the monopolies, these dissolutions have rarely, if ever, restored truly competitive conditions. For example, the Standard Oil Company of New Jersey, a holding company which controlled a large part of the petroleum refining business, was ordered dissolved in 1911. The dissolution, however, consisted of giving the stockholders of the holding company their proportionate shares of the stock of the underlying companies, so that these companies continued to be controlled by the same people as before. As a result, there has been some doubt as to the degree to which the successor companies have competed with each other since the dissolution. It may be argued, of course, that the dissolution prevented the trust from maintaining or further perfecting its control over the oil business as time went on, and that new companies have arisen to compete with the successor companies, even if they have not competed with one another. However, in view of the absence of price competition among the major companies in the industry at present, it must be held that the dissolution was a failure in many respects. Other examples of unsuccessful attempts to dissolve monopolies might readily be cited.

The Federal Trade Commission Act and the Clayton Act were somewhat more successful than the Sherman Act, because they represented a partial change in policy. That is to say, they followed the policy of legislative regulation and administrative supervision of competition, rather than the traditional policy of "trust-busting" and enforced competition. In recent years, however, monopolies have become more difficult to control, since many of them arise out of the activities of trade associations or result from the secret and informal cooperation of large firms between which there are no actual agreements or combinations. Finally, none of our anti-trust laws are applicable directly to the larger problem of monopoly controls *between* rather than within industries or to the domination of the economy by large business and financial units.

OUR FUTURE MONOPOLY POLICY

The Enforcement of Competition.—There are some people, even today, who believe that the government should continue its policy of "trust-busting" and enforced competition, attempting to make this policy more effective than it has been. They would like to see the incorporation of

change the mint ratio frequently so that it will conform to the market ratio. For this would mean, among other difficulties, the circulation of coins alike in face-value and yet different in their metallic content.

Overvalued and Undervalued Money.—Because of the variability of the market ratio and the fixity of the mint ratio, it is next to impossible to maintain a bimetallic standard over a long period of time. If, under a *monometallic gold standard*, an exceptionally large amount of silver were mined in 1942, the 1940 market ratio of 100 to 1 might be expected to change to (say) 102 to 1. This would represent a fall in the value of silver, attributable to the substantial increase in the quantity available. But if a *bimetallic standard* were in force, this increase in quantity would not lower the price of silver, since the mint ratio, set by law, would presumably remain fixed at 100 to 1. Under these conditions, silver would be overvalued and gold undervalued at the mint—that is to say, silver would command a higher price at the mint than on the market, and would therefore be sold only at the mint. As a consequence, the *theoretical* market ratio of (say) 102 to 1—which, as we saw above, would prevail in the presence of a monometallic gold standard—would be non-operative as long as silver could be disposed of more advantageously at the mint than on the market. Silver would tend to flow into the mint and gold to flow out, and these movements of silver and gold would likely continue until all the gold had been drained from the mint and only silver remained to serve as money; whereupon the market ratio would become operative and the mint ratio non-operative. The gold coins that had left the mint might be melted down and sold as bullion, be exported to other countries where they had greater purchasing power than at home, or possibly be hoarded in the hope that their exchange value would later increase.

If, on the other hand, gold were mined in unusually large quantities, the situation would be reversed. Gold bullion would then be brought to the mint, silver would flow out and disappear from circulation, and gold money only would be used for purposes of domestic exchange.

Gresham's Law.—This tendency for money that is overvalued *at the mint* to drive out of circulation money that is undervalued, is known as Gresham's Law. The law is effective only when there are free and unlimited coinage of both metals, free melting, and full legal tender of both gold and silver. Moreover, the quantity of the overvalued money must be sufficient to meet the needs of business transactions; otherwise the two may circulate side by side.

ounce. On December 31, 1937, this price was reduced to 64.64, but on July 6, 1939, was set by law at 71.11 cents for silver mined after July 1, 1939. The market price of silver bullion in general is, at this writing, about 35 cents an ounce. At the artificially high price the government is paying for newly mined silver, the bullion that goes into a dollar costs about 55 cents, but melted down and sold in the silver bullion market it would bring only 26 cents.

26. Summarize the work of the Temporary National Economic Committee, and comment on its recommendations.
27. What is meant by the policy of monopoly recognition and control? What criticisms may be directed at this policy?
28. What are the arguments for and against government ownership and operation as a solution for the monopoly problem?

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There are many illustrations of the operation of Gresham's Law. An example which illustrates that the law is applicable to paper money as well as to gold and silver, is to be found in the circulation of greenbacks during and following the Civil War. From 1862 to 1879 these notes were not redeemable in gold. Though they had been declared legal tender, greenbacks were generally regarded as distinctly inferior to silver and gold. Persons having in their possession both metallic money and greenbacks held fast to the metal and paid in paper. Since sufficient greenbacks had been issued to carry on business operations, gold and silver were withheld from circulation and paper money was used almost exclusively. Inferior money had driven superior money out of circulation.

Gold and Silver Purchase Plans.—Returning to the monetary system of the United States, we may note once more the extensive purchase of gold and silver bullion, begun by the government during the post-1929 depression.

Acting on authority given him under the Gold Reserve Act of 1934, President Roosevelt promptly reduced the gold content of the dollar, established a price of \$35 an ounce for gold, and ordered the Secretary of the Treasury to purchase gold bullion both in this country and abroad. Presumably, the purpose was to raise general prices in the United States to approximately their level in 1926, since it was thought that most of the business contracts outstanding were made when prices were at about the 1926 level and that a return to that level would aid in bringing about business recovery.⁶ It may fairly be questioned that the gold purchase plan raised prices as much as its sponsors had expected, but there can be no doubt that it brought an influx of gold bullion to the Treasury. The value of monetary gold in the United States was five times as great in 1941 as in 1932. This ten-year increase resulted partly from the greater value of gold (as expressed in terms of a dollar which contained fewer grains of gold than formerly), but it was attributable chiefly to large purchases of gold, both domestic and foreign, by the government.

In like manner, the Silver Purchase Act of 1934 added to our stock of metallic money. This Act declared it to be the policy of the United States to increase the stock of monetary silver until it constitutes one-fourth of the total monetary stock of this country, the other three-fourths consisting of gold. The Secretary of the Treasury was authorized to buy silver until this proportion of one to three has been attained. It was estimated that it would require the purchase of about one and one-third billion ounces of silver to bring about the proportion of gold and silver aimed at by the Silver Purchase Act. Since silver mines in

⁶ The part that an increase in gold may play in raising the price level is explained in chap. 36.

The Doctrines of Karl Marx.—A considerable difference of opinion has existed among collectivists as to when and how collectivism will arrive. In some quarters, collectivism is regarded as an ideal future state, to be attained only through extensive preparation and hard work. On the other hand, collectivism was regarded by Karl Marx and his followers as a system which will inevitably evolve out of capitalism, and which is already on the way whether most people realize it or not. The doctrines of Marx have had such a profound influence upon the advocates of collectivism that we must examine them briefly.

The Economic Interpretation of History and the Class Struggle.—Karl Marx held that economic matters are dominant in determining the course of history and that the form of government, family system, moral standards, and literature of a society are but reflections or by-products of economic activities and institutions. An important feature of capitalism, according to Marx, is the continuous class struggle. The two opposing classes are called by different names at different times in history, he said, but the struggle goes on all the time. The class struggle at present is supposed to be between the capitalist (or owning) class and the proletariat (or working) class.

Value and Surplus Value.—Prominent among Marx's theories were those relating to value and what he termed "surplus value." He held that all commodities, regardless of differences in size, shape, composition, and usefulness, contain a certain common element; that is, the labor used in producing them. Capital, though useful in production, he regarded merely as past labor congealed in a more or less permanent form. The values of commodities in terms of each other depend upon the amount of socially necessary labor contained in them. For example, a commodity that takes twice as much socially necessary labor to produce as another commodity should have twice as much exchange value.

From this theory of value, Marx derived his explanation of the method by which workers are exploited by capitalists. Under capitalism, the workers cannot work for themselves because they are unable to acquire the land and capital needed in production. Consequently, they must work for the capitalists who own these material means of production. As a condition of employment, the workers must turn their products over to the capitalists who are free to sell them for whatever they will bring, which will be an amount proportionate to the labor contained in the products. On the other hand, the wages which the capitalists pay to the workers need only be high enough to maintain the laborers and their families, and to permit them to raise enough children to take their places. The difference between the value created by the workers in production and the wages paid to them is called "surplus value," and goes to the capitalists as an unearned increment. The workers cannot refuse to make this bad bargain, because they are dependent upon the capitalists for a chance to

the United States had been producing some 25 million ounces of silver a year, this proposed change in our monetary stock was expected to provide a market for all silver mined in this country for two decades. This silver may be coined into silver dollars, or may be put into circulation through the issuance of silver certificates. In either event, the Silver Purchase Plan, if carried through to its stated conclusion, will add materially to the monetary stock of the United States. It has already increased the total amount of United States money by more than a billion dollars. Of course, every purchase of gold (under the Gold Reserve Act) requires an additional purchase of silver (under the Silver Purchase Act), if the proposed proportions of one to three are to be reached.

The present bullion content of the silver dollar (which the President of the United States has authority to lower) is 412.5 grains of silver nine-tenths fine, so that one ounce of silver makes \$1.29 worth of silver coin. Since the present Treasury purchase price for newly mined American silver is 71.11 cents an ounce, it will be seen that every time the government buys an ounce of silver and turns it into coin, it makes a "profit" of approximately 58 cents.

The Managed, Inconvertible Gold Currency System of the United States.—The recent changes in monetary practice in this country make it necessary to find a new term by which to designate the present currency system of the United States. Clearly, the old title—"the gold standard"—is no longer applicable, since one of its essential features—the power to redeem all forms of credit money in gold upon demand—has disappeared. Probably we can do no better than to call our present arrangement a "managed, inconvertible gold currency system."⁷

It is a *gold* system, since our standard unit, the dollar, is still defined in terms of gold, and the security back of our money consists in large part of a stock of gold bullion. However, "gold is relegated to a distinctly nominal rôle. . . . The commodity gold, consequently, may be said to function as an inspirer of confidence in money on the part of the public."⁸ Furthermore, we have an *inconvertible* system, inasmuch as none of our money in actual circulation is redeemable in the standard money, gold. Finally, the system is *managed*; that is, the quantity of money is not allowed to adjust itself on the basis of the presentation or withdrawal of gold at the mint and the issuance of bank notes of various kinds, but is presumably being managed by a central authority (the President of the United States) in an attempt to adjust the price level in such a way as to bring about the full use of the country's productive resources.⁹

There are, in the main, four ways in which the President, if he deems

⁷ This is the term adopted by Professor Ralph A. Young in *The New Monetary System of the United States* (New York, National Industrial Conference Board, Inc., 1934).

⁸ *Ibid.*, p. 29.

⁹ Cf. *ibid.*, p. 29.

to stamp as a socialist any person whose views on economic matters differ from their own. The term socialism, to us, means an economic system in which the material (that is, non-human) means of production are owned and managed by society. Communism includes all of this and a good deal more. For under communism consumers' goods would be collectively owned and arbitrarily distributed among the populace, in addition to land and capital being owned and operated collectively.

The Collective Ownership of Land and Capital.—Under both socialism and communism, then, the material means of production—that is, land and capital—would in general be owned by society and not by private individuals. But this does not necessarily mean that all land and capital would be owned by society. Individuals might be allowed to own plots of land as home sites, and even to own the land and capital needed in the operation of small business enterprises, such as shoe-repair shops and corner stores. Some socialists question that it would be wise for society to try to own and operate the land and capital used in agriculture, which is so largely a decentralized industry. Individuals would certainly be allowed to own such goods as lawn mowers and washing machines with which to perform services for themselves; and it would be exceedingly difficult to prevent people from performing similar services for others for pay, or from hiring these goods to others on a rental basis. An insistence on the complete and absolute ownership of land and capital by society would probably weaken, rather than strengthen, the socialist position. However, the essential fact remains that, under socialism, the land and capital used in all major industries, with the possible exception of agriculture, would be owned by society, and private individuals would no longer receive rent and interest for the use of these productive agents.

Opinions differ as to the method by which land and capital would be brought under the ownership of society. It is sometimes suggested that the present owners should be expropriated by violence and revolution. In general, it is probable that communists incline more strongly toward this point of view than do socialists. Many people realize, however, that such measures, while they might bring quick and thorough results, are subject to grave dangers. They are likely to repel all who are motivated by humanitarianism. Moreover, to cut down ruthlessly the present owners of land and capital would deprive society of some of its most capable executives and administrators. And if revolution were attempted but failed, society might well swing to the opposite extreme so that collectivism would be impossible for many years to come; but a failure to achieve collectivism by democratic processes at any one time might be followed by success a little later. Finally, if revolution resulted in a stoppage or breakdown of economic activities for any considerable period of time, an indescribable amount of suffering and loss of life would almost certainly result.

such action advisable, could increase the quantity of currency in circulation, thus "managing" it in the interests of higher prices. The first is the issuance of gold certificates to the extent of 2.8 billion dollars, which is the amount of "profit" realized by the government through calling in gold dollars weighing 25.8 grains nine-tenths fine and then revaluing the dollar at 15 5/21 grains. The second is the exercise of authority granted him by Congress to issue inconvertible paper money (greenbacks) for the purpose of paying a part of the public debt, this money (not to exceed 3 billion dollars) to be retired at the rate of 4 per cent a year. Third, the Treasury has been authorized to purchase silver to an amount that will make the silver reserves of our monetary system one-fourth of the total reserves, and to issue silver certificates against this stock of silver. Finally, the President has been authorized to reduce still further the bullion content of the gold dollar (though not to a point below 12.9 grains of gold nine-tenths fine); to reduce also the bullion content of the silver dollar; and to issue gold and silver certificates up to the full amount of "profit" realized by these reductions. We have here the means of increasing materially the quantity of government paper money; and since such money may be used as the basis for issuing Federal Reserve notes and Federal Reserve bank notes and also (as we shall see in the next two chapters) as the basis for extending bank credit which circulates through the use of bank checks, the President's power to expand our "circulating media" is very great. Our present monetary system, therefore, is clearly a managed system.

Money is anything that serves as a standard of values, or is generally acceptable and is used primarily as a medium of exchange.

Standard money is money that contains the amount of metal necessary to make its value as bullion exactly equal to its value as money.

A *United States dollar* is 15 5/21 grains of gold nine-tenths fine.

Free coinage is the coinage of bullion in unlimited quantities (though not necessarily without charge) upon presentation at the mint.

Legal tender is money which by legal declaration must be accepted by a creditor in payment of debt, in the absence of an agreement to the contrary.

Gresham's Law: Money that is overvalued *at the mint* tends to drive out of circulation money that is undervalued.

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1. Name the different kinds of paper money in the United States. The different kinds of metallic money.
 2. What is a "dollar"?
 3. What do we mean by "standard money"?
 4. In view of our definition of "standard money," why do we sometimes refer to "standard silver dollars"? Explain the seeming contradiction.

be divided equally among the income-receiving citizens or shall there be differences in incomes, and if there are to be differences upon what basis shall the differentiation be made and to what extent? Some socialists contend that all should share alike, although it is not always clear whether this means an equal share for every man, woman, and child or equal shares as between families. Sharing equally would probably mean, to these socialists, the equal sharing of money income, while real income would vary in composition from one individual or family to another. Many socialists recognize the difficulties of getting people to work hard, or to take the more responsible and important positions in our economic system, if all persons are to have equal incomes; and consequently they advocate that there be some variations in income as between individuals, based upon differences in ability, or efficiency, or both. However, most communists, and some socialists, hold out for an entirely different principle of distribution, urging that individuals should contribute to production on the basis of their ability and receive income on the basis of their needs. This might mean that those who contributed most heavily to production would draw the smallest incomes because their needs were slight. In general, we may consider the principles of equal distribution and of distribution according to needs, as ideals rather than practical proposals. In practice, a collectivistic economic system would probably have to tolerate an unequal distribution of income based upon the productivity of its citizens.

One thing seems certain, however. The degree of economic inequality which would exist would be very small as compared with that which we have today. Since society would own the land and capital, private individuals would not receive, under socialism or communism, any incomes from rent and interest. Of course, different pieces of land would vary in productivity under collectivism as under capitalism, but the fruits of these variations in productivity would be spread over society as a whole, whereas now they go to a relatively small group of landowners. Similarly, a collectivist society could not do without capital goods, but these goods would be furnished by society as a whole and the rewards for saving and waiting would be reaped by society as a whole. Since industries would be run by society, the enterprisers and managers would be servants of the state and would be paid a stipulated wage; they would not, of course, receive any income in the form of profits as at present. All income would be distributed in the form of wages, except that provision would have to be made, in some way or other; for those who were unable to contribute to production. While differences in income would probably be permitted on the basis of efficiency and ability, we may be quite sure that even the most important executives and managers would not draw incomes of \$100,000 to \$1,000,000 a year as some do at the present time. But wages in general would, under socialism or communism, be consid-

5. In what way do gold and silver certificates differ from other kinds of paper money?
6. What is "representative money"? Illustrate.
7. What is "convertible money"? How is its convertibility maintained?
8. Define "inconvertible money," and give illustrations of its use in the United States and elsewhere.
9. Give a synonym for "inconvertible money."
10. Why is the use of inconvertible money generally regarded as objectionable? Illustrate.
11. Why, since the use of inconvertible money often results disastrously, do nations ever permit its use?
12. What proportion of the total money of the United States is "money in circulation"? Explain.
13. Define "money."
14. Name and describe the attributes of a satisfactory money.
15. What is the relationship between "acceptability" and the other attributes of money?
16. Is a personal check "money"? Explain.
17. How does money become "legal tender"? How is legal tender related to "acceptability"?
18. Why is it desirable that "coinage" be conducted under strict governmental control?
19. What is the meaning of "free coinage"? Of "gratuitous coinage"?
20. Four functions of money are described in the text. Name these functions, with a short explanation of each.
21. Why does money fail to perform perfectly its functions as a "standard of values" and a "standard of deferred payments"?
22. Distinguish between "monometallism" and "bimetallism."
23. Why is it difficult to maintain a bimetallic standard?
24. State and explain Gresham's Law.
25. Discuss the Gold and Silver Purchase Plans.
26. What kind of monetary system has the United States at the present time? Explain.

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a whole require these goods in abundance. This conflict of interests, collectivists say, would be eliminated under collectivism. Those who managed and directed the affairs of industry, being merely employees of society and unable to make profits for themselves under any circumstances, would have no incentive to restrict production in any industry. Their interests, like those of society, would be best served by producing in abundance. Moreover, it is said, collectivism would provide a remedy for the present practice of delaying the introduction of new inventions, in the interest of large profits, and consequently the best equipment and methods would be promptly available for all productive units.

It is argued, also, that the ordinary workers in industry would be more efficient under collectivism. Since they would be working for society instead of profit-seeking private enterprisers, they could count on getting their full share of the national income. As a result, labor unrest, strikes, boycotts, and other types of labor troubles should disappear. And since there would be work for all, and no fear of unemployment, there would be no incentive for workers to "soldier on the job" to make their jobs last, or to oppose the introduction of scientific methods, improved machinery, and labor-saving devices. By removing the greater part of the present conflict between individual and social interests, it is held, collectivism would contribute greatly to the efficiency of production.

The Elimination of Business Depressions.—Under either socialism or communism, it is said that business depressions would be unknown. The supply of purchasing power under socialism would be completely controlled by the central government and would never be allowed to operate, as it sometimes does under capitalism, as a force making for business booms and depressions. Production would no longer be planless and chaotic, because decisions as to what and how much should be produced would no longer be left to thousands of independent and uncoordinated individuals as under capitalism. Final decisions of these kinds would be made by the central authority, and misdirected production would not occur unless the central agency made mistakes in gauging the desires of consumers or were unable to meet these desires. Since production under collectivism would still be roundabout in character and would still be undertaken for a future market, it would be quite possible for misdirected production to occur. However, with the selling prices of products completely under the control of the central authority, it would be possible to induce consumers to take an unusually large output of some good off the market by lowering the price sufficiently or to restrict the consumption of another good, limited in quantity, by raising the price. Since costs and prices would mean little in such a system, misdirected production, when it occurred, would not be a force making for economic depression.

Moreover, under collectivism there would never be an incentive to close down an industry or to reduce its output, unless the desires of con-

CHAPTER 33

COMMERCIAL BANKING IN THE UNITED STATES

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ONE OF the functions of money, as we saw in the last chapter, is to serve as a medium of exchange. Not only standard money but "credit money" (underweight coins and paper money) is useful in the performance of this function. But money, whether standard or credit, plays only a small part in the actual business transfers of the country, when compared with such "credit instruments" as checks and drafts. Gold, when used as a reserve against other kinds of circulating media, is a more vital factor in the business world than it could possibly be as an active medium of exchange. For its use in this way permits the circulation of a vast quantity of credit which is constantly employed in furthering business activities. It is a fair estimate to say that fully 90 per cent of our business operations are carried on through the use of substitutes for money. The check is, in present-day business, the most important of money substitutes.

Two Important Types of Credit.—The need for credit arises largely from the fact that production is carried on in anticipation of demand. This means that many of the costs of production must be borne for some time before any return is realized by the sale of the product. If a silk loom is about to be discarded, then the part contributed by this loom to the last yard of cloth that is woven is a cost of production which was met perhaps some twenty years before the sale of the silk cloth. The ability to conduct an enterprise and the possession of a large amount of money do not always go together. Frequently, then, enterprisers are obliged to put their ideas to work, not with their own resources but with the aid of borrowed capital.

Let us consider, by way of illustration, the case of an energetic young man of business ability, with confidence in the future of television, but with no money of his own. Obviously, he must secure credit if he is to go into the business of manufacturing television receiving sets. The purchase or lease of land, the construction of a factory building, and the purchase of machines and tools require funds in considerable amounts. Moreover, these funds will be "tied up" for a long period of years, being invested in plant and equipment designed for a particular purpose. What our would-be enterpriser needs is *investment credit*; that is, *long-time* loans, amounting to *large sums*, to be put into *fixed* capital. Such loans

sumers' goods to make possible the creation of any required amount of capital goods, however large. Thus, saving and investment would really be a single process under collectivism.

CRITICISMS OF COLLECTIVISM

Collectivism and the Family.—It is small wonder, then, that collectivists find in the possibilities of their projected social order a picture which they think should be attractive to many who suffer from the imperfect workings of capitalism. However, it would not be fair to leave the subject of collectivism without considering some of the objections which are raised against the proposals we have described. Some of these objections are weighty indeed, while others do not appear to be so well founded. We shall discuss the latter objections first.

There is a widespread idea in this country that socialism or communism would involve the breakdown of the institutions of marriage and the family, and that collectivists believe in "free love," the nationalization of women, or some other radical idea with respect to relations between the sexes. Now, it is undoubtedly true that some collectivists harbor extreme ideas of this kind, but so also do many individuals who are not collectivists. In general, collectivists are inclined to believe that marriage and the family would reach their most perfect development under collectivism, because these institutions would then be freed of economic considerations. With a fair distribution of the national income, an ambitious young man would have no need to marry the boss's daughter, nor would a woman be tempted, for economic reasons, to espouse a rich but otherwise unattractive individual for whom she had no real affection. No one would be forced to abstain from marriage because of economic necessity, and marriage and the family would come to have a sound basis in mutual admiration and affection.

Collectivism and Religion.—In like manner, there is a popular notion that collectivists are atheists and would put an end to religious activities. Now it is true that collectivists are usually bitterly opposed to state churches, whenever these religious institutions work hand in hand with the political organization to keep the people in subjection. Undoubtedly, some collectivists are disgusted with the religious institutions of the present time; and it is likewise true that some people who are collectivists, and others who are not, convinced as they are that social reform can be accomplished here and now, are impatient with any religion which encourages people to be humble and resigned to hardship and privation in this world so that they may be more fortunate in the next. However, there is little or nothing in collectivism to support the belief that, in a new social order, religious activities of all kinds would be ruthlessly suppressed and discouraged.

are usually secured through the issuance of bonds and shares of stock.

Even after the business is well established and is operating on a profitable basis, there may be times when this enterpriser will need additional funds for short periods of time. There are certain running expenses that must be met promptly, raw materials to be purchased, wages to be paid. And even though the books show a handsome profit, funds may be tied up temporarily in the form of goods manufactured and on hand, or television sets sold to wholesalers but not yet paid for. However, the running expenses of the company must be met, and without delay, so that an appeal is made for *commercial credit*, which consists of *short-time loans*, for relatively *small amounts*, to supply *circulating capital*.

SOME IMPORTANT CREDIT INSTRUMENTS

Book Accounts.—Our suggestion that some of the television sets that were sold had not yet been paid for indicates that this enterpriser is extending credit to his customers, probably through book accounts. There is little credit mechanism involved in the process. Let us suppose that, in order to dispose of a substantial number of receiving sets held in stock, the enterpriser agrees to deliver one hundred sets to a wholesaler, waiting sixty days for payment or allowing 2 per cent discount for cash in ten days. This transaction now stands as an "account receivable" on the books of the seller and an "account payable" on the books of the buyer, to be canceled as soon as payment has been made.

Promissory Notes.—A transaction of this kind might be handled through the use of a promissory note. This is an agreement to pay, "for value received," a stated amount of money at a specified time and place. When properly endorsed, a note becomes "negotiable"—that is, it may be bought and sold. The payee of a note (the person who is to receive payment) is likely immediately to endorse it (by signing his name on the back) and have it discounted at his bank. The process of discounting consists of the bank deducting in advance the interest charge for the period of time indicated in the note, and placing the remainder to the credit of the payee. The payee is then in a position to write checks against his account with the bank, to the full amount of this credit. An endorsement on a promissory note or check makes the endorser responsible for its payment in case the drawer of the instrument fails to make good his obligation.

Drafts, Bills of Exchange, Trade Acceptances.—The *draft* is a very common device used in extending credit. This instrument appears under several names, such as *bill of exchange*, *trade acceptance*, and so on. The method of using the draft, also, is not entirely standardized. Sometimes the draft is accompanied by a bill of lading, warehouse receipt, or other claim upon property; sometimes, again, it travels alone. At times, the transaction is handled through a *bank draft*, which is an order drawn

point out that very few inventors reap great rewards under capitalism, since most of the profit that results from their efforts goes to business men who exploit the inventions. Nevertheless, inventors continue to work, apparently largely for the sheer joy of devising new things, or for other non-economic reasons. Moreover, many inventions have been made by university or governmental employees who have not attempted to turn their devices into private gain.

In discussing incentives we are admittedly on uncertain ground. People have long been arguing about the extent to which man requires economic gain if he is to be stirred to productive activity and the extent to which he may be spurred on by other motives. It seems clear that there are very considerable differences among individuals as to their reactions to incentives, and that the matter must be submitted to the test of further experience.

Freedom Under Collectivism.—Finally, there are some people who urge that collectivism should be avoided because it could succeed, if at all, only through regimentation, and the subordination of the individual to society. A person would no longer be free to follow his self-interest in his own way, he could not choose his own field of enterprise and decide how much or how little to produce, nor would he be allowed, as he is allowed today, to pile up wealth and spend or give it away as he might see fit. Under collectivism the interests of society would be superior to the interests of individuals. It were better by far, say the exponents of individualism, to have liberty and possible poverty, than to enjoy a comfortable, assured income at the cost of one's freedom.

But the collectivists answer this argument by saying that most people, under capitalism, have very little freedom to lose. Political freedom they may have, but few indeed enjoy true economic freedom. Freedom of enterprise and self-interest, for most people, are a snare and a delusion. The average man chooses rather the corporation for which he will work, than the line of business into which he will go as enterpriser. The captain of industry says "Come," and thousands of people have work. He says "Go," and the same thousands are idle and must turn to charity or relief for their maintenance. He decides to lower wages and his employees tighten their belts, and grin and bear. If the workers organize in order to bargain collectively, the great industrialist attempts to smash their union, if it is of a type which he will be unable to control. If the government legislates on hours and wages, the courts void the laws and protect the workers' right to work for as low wages as they will, rather than to let their freedom of contract be destroyed. If this be freedom, say the collectivists, it is the freedom to starve rather than to earn a fair living. And hence they conclude that most people are wage slaves under capitalism and can be set free only by collectivism.

Cumulative Dissatisfaction Under Collectivism.—We have now examined the most serious objections to collectivism, but we may mention

by one bank on another. In all cases, however, the general principle is the same. A draft is an order written by one person to another, ordering that a specified amount of money be paid to a third person, sometimes (though not always) on a stated date. It follows that the familiar bank check is a form of draft.

A business transaction may give rise to the type of credit instrument shown in Fig. 49. This is a trade acceptance, a form of the draft, and as here drawn it orders the New York-Jacksonville Transit Corporation to pay to the Johnson Airplane Company, in sixty days, the sum of

TRADE ACCEPTANCE Standard Form Approved By AMERICAN ACCEPTANCE COUNCIL New York	No. <u>453</u>	<u>New York</u> (City of Drawer)	<u>Oct 1, 1942</u> (Date)
	On <u>November 30, 1942</u> Pay to the order of ourselves (Date of Maturity)		
	<u>Sixty Thousand</u> — Dollars (\$ <u>60,000</u> ^{xx} / ₁₀₀)		
	The transaction which gives rise to this instrument is the purchase of goods by the acceptor from the drawer. The drawer may accept this bill payable at any bank, banker or trust company in the United States which such drawee may designate.		
	<u>To New York-Jacksonville Transit Corporation</u> (Name of Drawee)		
	<u>New York, N.Y.</u> (City of Drawee)	By <u>William Johnson</u> (Signature of Drawer)	

FIG. 49.—A TRADE ACCEPTANCE (one form of the draft)

\$60,000. This trade acceptance, or draft, is forwarded to the Transit Corporation, and the Corporation "accepts" it by writing across the face of the instrument the word "Accepted," the date, the name of the bank at which it will be paid, and finally the signature of a responsible official. Not only trade acceptances but drafts in general are "accepted" in this way.

Thus endorsed, the trade acceptance is negotiable, and may be readily discounted. The statement that "the transaction which gives rise to this instrument is the purchase of goods by the acceptor from the drawer" makes the paper acceptable at Federal Reserve banks. The Federal Reserve System is designed to aid only in the financing of legitimate short-time business operations; and the statement that we have quoted is inserted as evidence that the proceeds of this trade acceptance have not been used for a permanent investment, or for one of a purely speculative character.

A draft when accepted by the drawee (the person to whom it is addressed) becomes virtually a promissory note. If William Johnson, on behalf of the Johnson Airplane Company, discounts the trade acceptance shown in Fig. 49, he must himself endorse it and it thus becomes

with the exception of the insane and persons deprived of electoral rights by court sentence. All classes of voters have equal rights of representation in the legislative bodies, and elections are by secret ballot. However, there is still much economic rather than geographical representation, for this principle is fundamental to the Russian system.

Under the present constitution, equal rights are guaranteed to all citizens. All are granted freedom of speech, freedom of press, freedom of assembly and of holding mass meetings, freedom of street processions and demonstrations, and freedom of religious worship. Citizens are guaranteed inviolability with respect to their persons, homes, and correspondence. Going beyond the constitutional provisions of other countries, the Russian constitution guarantees the citizens employment and payment for their work in accordance with its quantity and quality, the right to rest and leisure, the right to maintenance in old age, sickness, and accidents, and the right to education. Women have equal rights with men in all spheres of life.

The Dictatorship.—In theory, then, the present Russian constitution and government appear most enlightened and democratic. In practice, the people of Soviet Russia live under a dictatorship, as they did before the present government was established. In theory any person, whether a member of the Communist Party or not, may run for office. In practice, all candidates save one in each electoral district usually resign before an election is held, and the one remaining candidate is the fortunate individual who is approved by the Communist Party. In the first election under the present constitution, almost 97 per cent of the eligible voters went to the polls and practically all voted for the single candidates available in their districts. In 1938, 81 per cent of the members of the Council of the Union and 71 per cent of the Council of Nationalities were also members of the Communist Party. The legislature usually votes unanimously for any party-sponsored projects which are placed before it.

Political crimes are regarded as the most heinous offenses that can be committed in Soviet Russia, and the dreaded secret police work day and night to ferret out persons suspected of political crimes and subversive activities. It is true that the Russian dictator, Stalin, has not usually bothered to hold any official position in the government, but as General Secretary he has ruled the Communist Party, which in turn has controlled the government. In short, as someone has said, the people of Russia "have absolute power provided they do as they are told by the leader through the instrumentality of the party."

THE PLANNING AND CONTROL OF INDUSTRY

In considering the operation of Russia's economic system, we must always bear in mind that Russia is under a socialistic system. That is to say, land and capital are socialized and are owned by society, the former en-

"double-name paper." This means that the amount advanced to the Johnson Airplane Company on the strength of this instrument will be charged back to the company if the New York-Jacksonville Transit Corporation does not make payment at the stated time.

THE NATURE OF COMMERCIAL BANKING

The Operation of a Commercial Bank.—An examination of the statement of a commercial bank will provide background for our discussion of commercial banking in the United States. Table 34 is such a statement for a small-town bank.

TABLE 34.—STATEMENT OF A SMALL NATIONAL BANK

<i>Assets</i>		<i>Liabilities</i>	
Loans and discounts (1).....	\$ 621,190.28	Capital (6).....	\$ 125,000.00
United States bonds (2).....	1,114,350.63	Surplus (7).....	150,000.00
Other bonds and securities (3).....	423,617.72	Undivided profits (8).....	78,182.52
Real estate and fixtures (4)...	101,040.17	Deposits (9).....	2,269,022.53
Cash reserve (5).....	361,406.25		
	<u>\$2,622,205.05</u>		<u>\$2,622,205.05</u>

We note, first, the bank's *liabilities*. The *capital* of the bank (Item 6) is the fund subscribed by its stockholders to enable it to start in business. The *surplus* (Item 7) consists of certain profits that have been assigned permanently to the operation of the business. The *undivided profits* (Item 8) are gains which may later be transferred to surplus, or may, on the other hand, be distributed to the stockholders in the form of dividends. Items 6, 7, and 8 constitute a fund which (says the statement) "becomes the property of the stockholders after the debts to the depositors are paid, and is a guarantee fund upon which we solicit new deposits and retain those which have been lodged with us for many years." These three items—capital, surplus, and undivided profits—are amounts *due the owners of the bank*. *Deposits* (Item 9) are amounts *due customers of the bank* who have left funds in the custody of the bank or to whom the bank has made advances against which these customers may write checks.

Since a commercial bank is a profit-seeking enterprise, its officers try to find investments for its funds which will pay a satisfactory return. The *assets* of the bank indicate the nature of these investments. *Loans and discounts* (Item 1) are sums lent to business men and others, usually on the basis of promissory notes or other "commercial paper," but sometimes on real estate or securities. *Government bonds* (Item 2) and *other bonds and securities* (Item 3) are investments to which commercial banks turn when more profitable business is not obtainable. Item 4, *real estate and fixtures*, covers the building, grounds, and equipment used in operating a bank. The *cash reserve* (Item 5) consists partly of legal re-

CHAPTER 52

FASCISM IN ITALY AND GERMANY

IN OCTOBER, 1922, Benito Mussolini directed the famous "march on Rome." Since that time, fascism in Italy has shown signs of becoming a relatively permanent system, so that we shall examine it in some detail and compare its essential features with those of our own political and economic system, and of Soviet Russia as described in the preceding chapter.

THE ITALIAN GOVERNMENT UNDER FASCISM

In popular discussions and writings that appear in the United States, fascism is often confused with socialism and communism. Indeed, certain officials in American public life have at times been called both fascists and communists, in the same breath, by their political opponents. While it is hardly possible for anyone to be both a fascist and a communist at the same time, it is true that, in the past, there have been sufficient points of similarity between the Italian and Russian governments to lead to the false conclusion that the entire systems of these countries were well-nigh identical.

The Italian Dictatorship.—Russia and Italy have been alike, in the first place, because both have had extremely strong central governments which controlled many of the economic and other activities of their citizens. Mussolini was summoned by the King, soon after the march on Rome, to form a Cabinet for the Italian government, and he has since been a supreme dictator, ruling the Italian people with an iron hand. Besides being Prime Minister, he holds several other important portfolios in the Cabinet, and has turned the others over to trusted associates. He is President of the Grand Council of the Fascist Party, a small body which acts in a consultative and advisory capacity on a wide variety of political, economic, and social matters. He alone can convoke the Grand Council and direct its activities. He is also the Minister of Corporations and President of the National Council of Corporations. In a word, Mussolini is, to all intents and purposes, the Italian government.

However, the King of Italy has been retained as the nominal head of the government, though in reality he holds no important powers. The Italian system has also retained a legislature, though the legislative body

serves held by the Federal Reserve bank of the district in which the commercial bank is located, and partly of cash in the vault of the bank itself. The assets, it will be observed, are items which are *owned by the bank or owed to the bank by others*.

Chief Functions of a Commercial Bank.—The banking functions which are peculiarly those of the commercial bank are (1) making loans and discounts, and (2) creating deposits for business concerns. In the operation of our economic system, business enterprisers continually find themselves in possession of certain types of purchasing power, or claims upon economic goods. These may take the form of commodities finished but unsold, or commodities sold but not paid for. Eventually, through the process of exchange, these goods will be paid for; but in the meantime the smooth, efficient operation of business demands that further raw materials be purchased, wages be paid, and other regular expenses of business operation be met as they fall due.

In situations such as these, commercial banks may render a great service to business men. By means of short-term loans, these banks substitute purchasing power of wide acceptability (money, or deposits subject to check) for purchasing power of limited acceptability (goods, notes, or drafts) held by the business concerns. A concern presents a promissory note or other acceptable credit instrument at the bank, and is granted a "loan" (which means that the interest charge will be paid when the loan falls due) or a "discount" (in which case the bank deducts the interest charge from the amount of the loan at the time it is made). In either event, the transaction is entered in the books of the bank as both an asset and a liability. It appears among "loans and discounts" as an asset—an item owed to the bank by its customer—and among "deposits" as a liability—an amount owed by the bank to its customer. With this deposit to its credit, the borrowing concern may proceed to write checks against it, though many banks require a borrower to maintain an unused *balance* of 10 to 25 per cent of his loan.

The ability to borrow in this way from commercial banks enables business men to purchase at once the commodities and services they must have, and later they pay off their obligations to the banks. From the point of view of the business men, loans are granted and credit is extended from time to time. From the point of view of society as a whole, a tremendous volume of credit is kept continually in circulation, and through the use of this credit the exchange of goods is facilitated.

To some present-day writers on banking, this description of the function of commercial banking might appear to be out of date and old-fashioned. It might be held that these short-term, self-liquidating loans based on actual business transactions have been playing a progressively smaller part in the business of commercial banks in recent years; while loans based on real estate, stocks and bonds, and similar investments have

during the first World War, though they were said to have needed several billion dollars' worth of overhauling when they were returned to private control. The use for war purposes of the land, labor, and capital which are saved by postponing non-urgent repairs might conceivably spell the difference between victory and defeat.

The War Production Board.—The fundamental object of wartime control of production is to insure that land, labor, and capital shall be put to the best possible uses. But, since someone must decide what is *best*, the existence of an agency of control implies the existence also of an agency which ranks projects and materials in the order of their importance to the war effort.

A number of agencies—chief among which was the Office of Production Management—performed the function of supervising and controlling production in the months which preceded the attack upon Pearl Harbor. But in January, 1942, the task of speeding and guiding the output of necessary goods was turned over to the War Production Board, which was established by two Executive Orders issued that month by President Roosevelt. Most of the older agencies of control were abolished or were reorganized and absorbed by the new Board. The War Production Board is authorized (1) to exercise general direction over the war procurement and production program, and (2) to determine the policies, plans, procedures, and methods of the several federal departments, establishments, and agencies in respect to war procurement and production, including purchasing, specifications, and construction, and including conversion, requisitioning, plant expansion, and the financing thereof; and to issue such directions in respect thereto as may be deemed necessary or appropriate.

The War Production Board has supplanted the Supply Priorities and Allocations Board established by Executive Order on August 28, 1941. The functions of the older Board were taken over through the transfer of the following six divisions to the War Production Board: (1) Division of Materials, (2) Division of Industry Operations, which handles priorities and conversions, (3) Division of Purchases, (4) Division of Labor, (5) Division of Civilian Supply, and (6) Division of Production. The present Board has thirteen regional offices, attached directly to the Division of Industry Operations and located in large cities from coast to coast, to facilitate the handling of local and regional problems.

The Production Requirements Plan.—The War Production Board aims to cover the whole field of war output under a system known as the Production Requirements Plan. The nature and operation of this Plan are described in *Fortune*, from which we quote the following description.

Under P.R.P. the manufacturer makes, on one big accounting form, a quarterly report of his past quarter's production and an estimate of his coming quarter's requirements—giving the War Production Board a close-up of total

become increasingly important. It is true that commercial banks do engage, to a considerable extent, in other types of banking. Some have savings departments, and thus collect funds which are set to work in long-term investments. Many commercial banks are also trust companies and handle, among other things, trust funds which require relatively permanent investment. Moreover, until recent years, some commercial banks have engaged, either directly or through affiliated companies, in investment banking operations connected with the promotion and underwriting of security issues; and prior to August 1, 1935, the national banks of the United States issued money in the form of national bank notes. Nevertheless, the fact remains that the principal function of commercial banks, *as such*, has been and continues to be that of supplying short-term credit to business men. On this subject we shall have more to say when we discuss the vital question of the safety of the deposits held by commercial banks.

The Credit-currency Structure.—We noted in the preceding chapter that less than 10 billion dollars of United States money is actually in circulation. This is a substantial sum, but the amazing growth of "deposit currency" (sometimes called "check currency") as a means of paying bills has forced money into a distinctly secondary position. Deposit currency consists of demand deposits created by commercial banks, and brought into circulation through the agency of bank checks. Demand deposits in this country totaled more than 44 billion dollars in 1940.

Demand Deposits (Deposit Currency).—It is estimated by experts that this huge amount of deposit currency has a "turnover" of twenty-five to thirty times a year; that is, that this sum is spent some twenty-five or thirty times in the course of a year. For although these deposits are being continually depleted by checks that are written against them, they are also being added to continually from several sources.

One of these, which is of relatively slight importance, is the deposit of money, checks, money orders, and claims upon cash, by means of which individuals and business concerns increase their balances, and against which they draw their checks as occasion arises. Much more important are the deposits that arise through loans and discounts. When a bank lends to a business concern on the basis of commercial paper, such as a promissory note or trade acceptance, it pays the concern the amount due in one of two forms—either in bank notes or in a demand deposit. If notes are taken, the business firm uses them in paying bills and thus distributes bank credit in place of personal credit. If the bank simply credits the account of the concern with the amount due, there is again an exchange of bank credit for personal credit, since demand deposits, like bank notes, are promises of banks to pay money on demand. And the business concern, paying bills with checks drawn against a demand deposit, again distributes the bank's implied promises to pay, in place of

its own. It is chiefly through loans and discounts, and not through the deposit of money in a bank, that demand deposits arise. It is important to emphasize this point, since it is one that is often overlooked by students of economics.

Another point that must be stressed is the fact that commercial banks deal mainly in short-term obligations; and this is one reason why the fund of deposit currency is being continually replenished. When a bank creates a demand deposit by granting a loan or discount, it *may* be required to pay out money every time one of this customer's checks comes in for payment, though in many cases the person presenting the check will merely ask the bank to place the amount to his credit so that *his* account may be increased. But in any case, the credit extended on commercial paper is ordinarily limited to a maximum period of ninety days, and at the end of that period the obligation must be paid by the borrower, unless the bank (if so requested) sees fit to renew the loan in whole or part. Since a bank handles thousands of transactions of this kind, its credit resources are in a state of constant flux, being in process of depletion through daily withdrawals, but being replenished all the while by daily deposits.

Bank Reserves.—Bankers are sometimes tempted to allow the extension of credit to go beyond the point of safety, for with each new loan a profit is realized. It would be disastrous, however, for a bank to be unable to pay a legitimate claim that is presented against it, since failure of this kind would result in the bank's closing its doors. Consequently, it has been the custom in this country to provide, by law, that reserves of a specified percentage be held against demand and time deposits. In the case of state banks not members of the Federal Reserve System, the amount of the required reserve is regulated by state legislation and differs somewhat from state to state. The amount that for twenty years had to be held in reserve by banks belonging to the Federal Reserve System against demand deposits was 13 per cent for banks in New York and Chicago, 10 per cent for those in cities of medium size, and 7 per cent for small-town banks; the reserve required against time deposits—those which cannot be withdrawn without "notice" of a month being given—was 3 per cent in all cases. The reserves are deposited with the Federal Reserve bank of the district in which the member bank is located. (The Board of Governors of the Federal Reserve System, by authority of the Banking Act of 1935, has several times changed the reserve requirements against demand and time deposits. The latest change, which went into effect on October 1, 1941, made these reserves 26, 20, and 14 per cent for demand deposits, and 6 per cent for time deposits. Since other changes may be made from time to time, we shall use the older, well-established figures in many of our illustrations.)

These reserves may appear at first sight to be absurdly small; but ex-

perience has shown that they are entirely adequate, for as long as confidence is maintained there is very little chance of depositors making a concerted demand upon the member banks for payment of the amounts due them. Furthermore, as our study of the Federal Reserve System will show, provision has been made for rendering "first aid" to any member bank that is threatened by a "run"—that is, by a demand for cash on the part of a large number of depositors.

The Clearing House.—Let us suppose that the Johnson Airplane Company has drawn a check for \$50,000 on the Corn Exchange Bank Trust Company in favor of the United States Steel Corporation. If the Steel Corporation happens to have an account in this particular bank, it will in all probability simply endorse the check and deposit it. The bank thereupon debits the Johnson Airplane Company with \$50,000, thus decreasing that company's deposit account, and credits the United States Steel Corporation with the same amount. In this way a payment is effected without any transfer whatsoever of actual money. All that has been done is to make a book transfer.

If the Steel Corporation should be doing its banking business with another institution, say the Chase National Bank, it would still make no direct appeal to the Corn Exchange Bank for payment of the check in cash. In this case, the check would be endorsed and deposited with the Chase National Bank, and this institution (and not the Steel Company) would proceed to make collection. Time was when the procedure followed was to send out daily a "runner," or messenger, from one bank to another, to make collection in cash for credits that had accumulated in the course of the previous day's business. The second bank would likewise send a representative to the first bank, to receive payment of any amount that might be due by reason of credit instruments held against this bank. It is obvious that this duplication of effort meant waste, and as banks increased in number the expenditure of time and effort increased at a still faster pace.

But this method of collection has long since given way to the "clearing house." This is a central agency, the main purpose of which is to effect daily settlements between the banks of a given area. If the Chase National Bank has claims against the Corn Exchange Bank, it is likely also that the Corn Exchange Bank has claims against the Chase National. Similar relationships exist between practically all banks of importance in any given city. In order to compare claims and make settlements, representatives of the various banks meet at the clearing house at designated hours every day. Each representative, or "settling clerk," presents the claims of his bank against other institutions, and receives in turn the claims of the other banks against his own. A balance is struck, either debit or credit, and the amount due is paid by the bank to the clearing house or by the clearing house to the bank, as the case may be.

Reference to Table 35¹ should help to make the procedure clear. Bank A, for example, presents at the clearing house claims upon Banks B, C, D, and E, in the form of checks drawn against deposits in these banks and cashed by Bank A for its customers. The total of these claims is \$12,550. But the other members of the clearing house present claims upon Bank A, as is seen in the first column, to the amount of \$13,050. If one set of claims is balanced against the other, it is evident that Bank A can square its account with the clearing house by paying the amount due, \$500. Banks D and E are obliged to pay, respectively, \$1305 and

TABLE 35.—HYPOTHETICAL EXAMPLE OF CLEARING HOUSE DEBITS AND CREDITS

Customers of	Deposited Checks Drawn in the Following Amounts on					
	Bank A	Bank B	Bank C	Bank D	Bank E	Total
Bank A.....		\$2,500	\$ 850	\$5,800	\$3,400	\$12,550
Bank B.....	\$ 3,600		1,800	575	1,350	7,325
Bank C.....	2,200	630		750	980	4,560
Bank D.....	4,200	1,200	680		560	6,640
Bank E.....	3,050	1,600	745	820		6,215
Total.....	\$13,050	\$5,930	\$4,075	\$7,045	\$6,200	\$37,290

\$75; while Bank B collects \$1395, and Bank C \$485, to which they are, respectively, entitled. Since total debits are bound to equal total credits, the clearing house finds itself, at the end of the day, exactly where it started. And yet, through a process of bookkeeping and the payment and collection of small balances, it has managed to adjust the claims existing among all its members. In our illustration given above, credits have been set over against debits, necessitating cash payments of only \$1880 to settle claims totaling \$37,290.

The expenses of the clearing house are borne by the member banks, each paying an amount determined by its average "clearings" in relation to the total. But these expenses are comparatively slight, for the clearing house provides a very economical means of settling claims between banks. Though the volume of clearings in cities like New York and Chicago is enormous, the transactions are carried through with a surprisingly small transfer of actual money. In some cities the balances that must be paid are as small as 5 or 6 per cent of the total clearings. In New York in a recent year, the percentage of balances to clearings was 11.04. In the hypothetical illustration given in Table 35, the balances paid were a trifle more than 5 per cent of total clearings. It should be

¹ Adapted from a table arranged by Dr. C. Louis Knight, and published in Paul F. Gemmill and associates, *An Economics Question Book*, New York, Harper & Brothers, 1931, p. 60.

added that banks may, and often do, pay their balances by drafts on the Federal Reserve banks of their districts. There are in all about 600 clearing houses in the United States.

Out-of-town checks are "cleared" (or collected) very largely through Federal Reserve banks. If, for illustration, a merchant in Leesburg, Virginia, buys goods from a wholesaler in New York City, paying with his check drawn on the Peoples National Bank of Leesburg, collection would be made in something like the following manner. The wholesaler first takes the check, properly endorsed, to his bank in New York. This bank deposits it for collection in the Federal Reserve Bank of New York. The check is now forwarded to the Federal Reserve Bank of Richmond. The Federal Reserve Bank of Richmond sends it to the Peoples National Bank of Leesburg. The Peoples Bank now settles with the Federal Reserve Bank of Richmond. Upon receipt of this settlement, the Richmond bank immediately credits the Federal Reserve Bank of New York; and the New York bank, in turn, credits the wholesaler's bank. The collection is now complete.

It is estimated that some 95 per cent of all out-of-town (or "country") checks are collected in this way. "For settlements between the Reserve Banks there has been set up that ingenious device, the gold settlement fund, lodged in Washington with the [Board of Governors], and represented by a gold credit on the books of the Treasurer of the United States. This fund is owned by all the Federal Reserve Banks, and settlements between Reserve Banks are daily effected by bookkeeping entries, on telegraphic advice, changing the proportion of the gold fund which the different banks own."² It will be observed that this is an arrangement similar in principle to the ordinary clearing house, but operating on a much larger scale.

THE FEDERAL RESERVE SYSTEM

Our treatment of commercial banking thus far has related chiefly to banks as individual units, but we now turn to a consideration of the centralization of certain commercial banking agencies in the United States, which may be said to date from the introduction of the Federal Reserve System. The Federal Reserve Act was passed in 1913, and the Federal Reserve System began operations in the following year. It substituted a somewhat centralized system of banking for a notoriously decentralized system, and was adopted chiefly for the purpose of providing (1) greater security for depositors, and (2) a larger degree of elasticity of credit. How these objectives were to be attained will be discussed after we have sketched the structure of the Federal Reserve System.³

² W. Randolph Burgess, *The Reserve Banks and the Money Market*, New York, Harper & Brothers, 1927, pp. 72, 73.

³ Our treatment of the Federal Reserve System is based largely upon W. R. Burgess, *The Reserve Banks and the Money Market*, New York, Harper & Brothers, 1927,

Federal Reserve Banks.—The basis of the system is twelve Federal Reserve banks, located in twelve important cities of the country. Since it was the aim of the Federal Reserve Act to coordinate to some extent all of the commercial banking operations of the United States, the country was divided into twelve "districts," known as Federal Reserve districts, and one Reserve bank was established in each district. Fig. 50 gives an idea of the territory assigned to each of the several districts. It will be seen that, in so far as area is concerned, the division is very unequal.

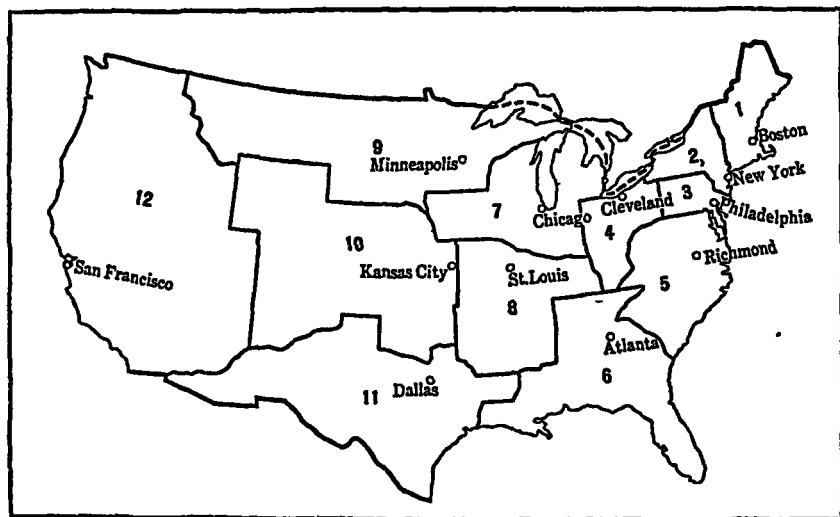


FIG. 50.—FEDERAL RESERVE DISTRICTS AND CITIES IN WHICH RESERVE BANKS ARE LOCATED

However, the basis of division was not territorial equality, but the establishment of Reserve banks at points where they would best serve the banking needs of the country.

In addition to these twelve Federal Reserve banks, there are now in all but two of the districts (the first and the third) "branches" of the Federal Reserve banks, which have been provided for the greater convenience of those banks which are situated at some distance from a main Reserve bank. Thus, in the twelfth district the Federal Reserve bank is located at San Francisco, but there are branches of this bank in Los Angeles, Portland, Seattle, Spokane, and Salt Lake City. In practice, then, there are in the twelfth district six centers to which Federal Reserve "member banks" of that district may apply for Federal Reserve service. There are, in all, twenty-five branches of Federal Reserve banks scattered throughout the country.

which gives a clear account of the organization and early operation of this development in American banking. We have also drawn upon banking experience in more recent years, and have noted changes in the System necessitated by its failure to meet some of the needs of the post-1929 depression.

The Federal Reserve banks are not government banks, nor yet are they ordinary commercial banks. They are often referred to as "bankers' banks," and this term indicates, first, their ownership by the member banks of the districts in which they are located, and, second, the fact that they perform for the member banks much the same type of service as these member banks perform for their customers. But it is important to note—and this is true of central banks in general—that the policies of the Federal Reserve banks are molded in the interests of public welfare, and are not directed primarily toward the goal of private gain. Indeed, their dividends are limited to 6 per cent, though all profits over and above this amount may be set aside as "surplus"; and upon this fund the banks are permitted to draw in order to pay the deficits of unprofitable years.

Member Banks.—Every national bank is required by the Federal Reserve Act to take out membership in the Federal Reserve System, and any state bank or trust company that has a capital of \$50,000 or more, and is approved by the Board of Governors, is eligible for membership. In acquiring membership, a bank must subscribe to stock in the Federal Reserve bank of its district to the amount of 6 per cent of its own capital and surplus; however, only one-half of this stock need be paid up, the other half remaining subject to call. The bank must also deposit all of its legal reserves with the Federal Reserve bank of which it is a member. These two items—subscription to stock in, and the deposit of reserves with, the Federal Reserve bank of the district—are the chief obligations of membership.

We have already noted the fact that each Federal Reserve bank is *owned* by the member banks of its district, and this ownership arises, of course, out of the purchase by the member banks of stock in the Reserve bank. The member banks also exercise a degree of control, but by no means complete control, over the Federal Reserve bank. Every Reserve bank is administered by a board of directors. This board is composed of nine members, and is divided into three groups of three members each. Three members are Class A directors, who are bankers elected by the member banks, which, as we have seen, are holders of stock in the Reserve bank. Three members of the board known as Class B directors, and also elected by the member banks, must be men actively engaged in industrial, agricultural, and commercial pursuits in the district. The remaining three directors, who are designated as Class C directors, are selected by the Board of Governors of the System, which will be described presently. It is assumed that Class A directors will represent the interests of the member banks, Class B directors the general economic interests of the district, while Class C directors (sometimes called "government directors") will represent the general public. The directors of each Federal Reserve bank elect a president, with the approval of the

Board of Governors, for a five-year period. He is the chief executive officer.

The make-up of the Reserve bank directorship indicates fairly clearly that its function is not that of the usual commercial bank. To be sure, it is intended that a Federal Reserve bank shall aid the banking interests of the district, but the inclusion of Class B members on the board insures that those groups of business men who depend upon the member banks for the extension of credit will have their interests looked after also, while the welfare of the public, in so far as it is dependent upon the operation of a central banking policy, will presumably be safeguarded by the Class C directors. The nature of the ownership and control of Federal Reserve banks appears to justify the statement which has often been made—that they are “semi-private, semi-public institutions.”

In 1940, there were 6486 member banks in the Federal Reserve System, with total banking resources of about \$62,650,000,000. These banks represented only 44 per cent of the commercial banks in the United States at that time, but they handled 87 per cent of the country's demand deposits.⁴ It may be added that 5144 of these member banks, or almost 80 per cent of the total, were national banks, the remainder being state banks and trust companies that had applied for and gained admission to the Federal Reserve System. Despite the advantages of Federal Reserve membership, particularly in the matter of security, some banks prefer to operate under state charters, which in many instances impose fewer restrictions on a very liberal extension of credit than do the rules of the Federal Reserve System. Thus there is the possibility of making larger profits under state than under federal regulation, but also a distinct sacrifice of safety. This statement is borne out by the fact that, in the financial crash that followed 1929, there were many more bank failures among non-member banks than among those which belonged to the Federal Reserve System.

The Board of Governors of the Federal Reserve System.—General supervision and control of the Federal Reserve System are intrusted to the Board of Governors.⁵ This body consists of seven members, and has its headquarters in the Treasury Building at Washington. Each member of the Board is appointed for a fourteen-year term by the President of the United States, subject to the approval of the Senate. Not more than one of the seven may come from any one Federal Reserve district, and it is stipulated that appointments shall be made with “due regard to fair representation of the financial, agricultural, industrial, and commercial interests, and geographical divisions of the country.”

⁴ W. H. Steiner and E. Shapiro, *Money and Banking*, New York, Henry Holt and Company, Inc., 2nd ed., 1941, pp. 520, 538.

⁵ The “Board of Governors of the Federal Reserve System” is the new name, designated by the Banking Act of 1935, for the body which, prior to that date, was known as the “Federal Reserve Board.”

When a bank takes out membership in the Federal Reserve System, it does not thereby lose its independence of action. It ordinarily continues to function much the same as before, conducting its operations in accord with national or state laws. The twelve Reserve banks likewise are largely autonomous units in dealing with their member banks. The amounts they lend to member banks, and the rates at which the loans are made, are ordinarily determined by each Reserve bank for itself through its board of directors. But the Board of Governors acts as a coordinating body in matters that affect more than one Reserve bank, to the end that the activities of one bank shall not interfere with the proper functioning of any of the other banks.

We shall not be able to discuss in detail the many tasks of coordination, regulation, and supervision that come within the jurisdiction of the Board of Governors, but we shall see that the Board exercises a considerable degree of control over the banking operations of the United States. The functions of the Board have been summarized by a former Federal Reserve official in the following statement:

The Board prescribes regulations governing methods and procedure of Federal Reserve operations in all those matters where uniformity is necessary. Discount rates are fixed by the several Reserve Banks subject to "review and determination of the [Board of Governors]." The Board has certain limited operating functions in serving as a central clearing house for check collections and wire transfers. It has a force of examiners who examine the Reserve Banks periodically, and it maintains a complete statistical record and analysis of Federal Reserve operations, much of which is made public through the Board's weekly press statements, monthly bulletin, and the annual report to Congress. In addition to these and a number of other specific functions, the Board exercises general supervision over the operations of the Reserve Banks.⁶

THE SECURITY OF BANK DEPOSITS

Because the demand deposits of a bank are liable to be drawn upon at any time without advance notice being given, it has been customary to establish legal reserves of specified ratios with which to meet the demands of depositors. State banks operating under the various laws of the several states have been required to maintain against deposits certain minimum reserves specified in the state banking acts. The result has been a decided lack of uniformity as between states. The reserves required of the national banks, prior to the passage of the Federal Reserve Act in 1913, were laid down in the National Bank Act, and applied to all national banks throughout the country, regardless of state boundaries, though the percentages required differed with the classes of cities in which the banks were located.

Bank Reserves Under the National Bank Act.—The Federal Reserve Act applies only to banks belonging to the Federal Reserve System, as the

⁶ W. R. Burgess, *The Reserve Banks and the Money Market*, p. 11.

National Bank Act of the pre-Reserve era applied only to national banks. Under both of these Acts, the banks of the country were divided into three groups, depending upon whether they were located in very large cities, cities of moderate size, or small cities or towns. These groups were classified as "central reserve city banks," "reserve city banks," and "country banks," respectively.⁷ Central reserve city banks and reserve city banks were required to maintain reserves amounting to 25 per cent of their total deposits, and the percentage for country banks was 15. These reserves took the form of lawful money, and in the case of central reserve city banks the whole of the legal reserve had to be kept *in their vaults* in readiness to meet the demands of depositors. Reserve city banks were required to keep one-half, and country banks two-fifths, of the specified reserves in their own vaults. The remainder they were permitted, if they wished, to deposit with approved banks in other cities. The reserve city banks could deposit one-half of their legal reserves in central reserve city banks, and the country banks three-fifths of their legal reserves in reserve city banks.

Since reserves thus deposited drew interest, while reserves held in their own possession did not, many of the banks cut down to the bare legal minimum the amount of legal reserves actually held in their vaults. Out of this situation arose the practice known as the pyramiding of reserves, which tended to weaken the ability of banks to mobilize their reserves in case of need. Let us suppose, for example, that a Philadelphia national bank had on its books demand deposits amounting to \$4,000,000. Since Philadelphia is a reserve city, the legal reserve against these deposits was 25 per cent, or \$1,000,000. But one-half of this amount could be deposited with a New York (central reserve city) bank, leaving in the vaults of the Philadelphia bank only \$500,000 as a reserve immediately available for the payment of \$4,000,000 of demand deposits which might be called for at any time. Presumably, the Philadelphia bank could also recall at will the \$500,000 deposited with the New York bank. But the New York bank was at liberty to treat this "reserve" as it would treat any other deposit; that is, it could and probably would retain in its vaults merely the 25 per cent reserve required by law, lending out the other 75 per cent, or \$375,000, at interest. If we imagine a series of "bank runs" injected into this situation, it is easy to see that the New York bank might find it difficult, or even impossible, to return the \$500,000 deposit on demand, and the Philadelphia bank in turn, in the absence of this part of its legal reserve of \$1,000,000, might be forced to close its doors because of its inability to pay on demand the claims of its depositors.

It might be suggested, of course, that even the full legal reserve of

⁷ New York and Chicago are now the only central reserve cities; 62 other cities (mostly large but some of only moderate size) have been designated as reserve cities; and all others are regarded, for Federal Reserve purposes, as "country" areas.

\$1,000,000 would be a small amount with which to try to meet outstanding deposits totaling \$4,000,000. And, indeed, it was discovered that the National Bank Act reserves of 25, 25, and 15 per cent did not always enable a bank to meet its legal obligations when confronted with a long line of insistent depositors clamoring for the payment of their claims. However, the difficulty lay not so much in the inadequacy of reserves as in the fact that, before the adoption of the Federal Reserve Act, every bank was, in time of emergency, very largely "on its own." Since the function of a commercial bank is to lend out its funds, no such bank can hope to have in its vaults sufficient money to pay off all of its depositors if they happen to present their claims at about the same time. When, under the National Bank Act, there developed in a given community a lack of confidence that took the form of runs on the banks, it was pretty much a matter of every bank for itself. One might perhaps expect neighboring banks to come to the aid of a bank in distress, lending it funds with which to pay off its depositors and thus helping to restore confidence throughout the community. This, to be sure, sometimes happened. But it is equally true that a besieged bank often called for help, and called in vain because other banks felt that they must hold fast to whatever reserves they had on hand so that they might meet the demands of their own depositors if the need should develop.

Centralization of Reserves Under the Federal Reserve Act.—The Federal Reserve Act undertook to overcome the inadequacy of bank reserves to meet the demands that might be made upon the banks by their depositors. The purpose, of course, was to effect an arrangement which would make it possible for every sound bank to remain open, in contrast to the old system of reserves under which many a bank had been forced to close even though its assets were greater than its liabilities. In the matter of demand deposits, the immediate payment of claims upon demand is imperative, and the fact that a bank has assets on which it could realize within a month or two will not save it from disaster if requests for the payment of demand deposits are not met today.

The new method of handling reserves involved not an *increase* in the size of reserves, as one might have expected, but instead a *decrease*. Under the National Bank Act, the reserve requirements for demand deposits and time deposits were the same, being 25, 25, and 15 per cent for central reserve city banks, reserve city banks, and country banks, respectively. With the passage of the Reserve Act in 1913, these requirements were changed to 18, 15, and 12 per cent for demand deposits, and in 1917 they were lowered to 13, 10, and 7 per cent, according to the class of the city in which the bank was located. The reserve against time deposits, applying uniformly to all member banks throughout the Federal Reserve System, was set at 5 per cent in 1913, and lowered to 3 per cent in 1917. (As was explained earlier in the chapter, the reserve require-

ments, since October 1, 1941, have been 26, 20, and 14 per cent on demand deposits, and 6 per cent on time deposits.) All legal reserves must be deposited with and held by the Federal Reserve bank of the district. The member banks do not receive interest on these reserve balances held by the Reserve banks.

This policy of pooling reserves enables the Reserve bank to give aid to any member bank upon which the depositors are drawing heavily. Formerly, the individual bank was expected to fight its own battles and to have on hand at all times a reserve large enough for any emergency. As we have seen, the reserves were often insufficient to meet the needs of the occasion. With the reserves of all member banks under the control of a central agency, the Federal Reserve bank of the district, further funds can readily be extended to the particular bank that needs them. Each district is so large that it is improbable that all banks throughout the area will require aid at the same time. It is scarcely likely, for example, that all of the six hundred and fifty member banks of the third district will need the assistance of the Reserve bank of the district at the same time. But all have deposited with the Reserve bank funds which form a large pool of reserves which are available for the use of any sound bank or banks that may need help. Further safeguards are the authorization to Reserve banks to "make advances to a member bank on its time and demand notes having maturities of not more than four months and which are secured to the satisfaction of the Federal Reserve bank," and the power of the Board of Governors to shift reserves from one Reserve district to another in time of emergency.

The principle involved in the centralization of reserves is similar to the principle of insurance. There is safety in numbers, for as numbers are increased the risk is spread. Since it is impossible to tell in advance which bank is going to be hard pressed, it was necessary under the old system for every bank to be prepared for the emergency. With the Reserve banks and the Board of Governors standing ready to give assistance whenever and wherever it may be needed, there is no necessity for so large a total reserve as heretofore. The device through which aid is ordinarily given is the rediscounting process, which will be described presently.

The Guaranty of Bank Deposits.—For some years after the adoption of the Federal Reserve Act, it seemed that the financial panics that had often accompanied business depressions were a thing of the past. But the post-1929 depression wrought such havoc among the commercial banks of the country that there was no question that the banking system of the United States was still far from perfect.

The causes of this heavy toll of bank failures will be discussed in the following chapter. We wish here merely to note the fact that the loss of the holdings of hundreds of thousands of depositors led to a demand for the federal insurance of deposits. The result was the creation of a plan

of federal deposit insurance, the details of which will also be presented in the next chapter.

THE ELASTICITY OF CREDIT

Commercial banks are operated primarily to supply credit to business men. If our enterprisers had the same credit needs from month to month and year to year, and hence required commercial credit in a continuous stream of uniform volume, the problem of providing elasticity of credit would be one of minor importance.

But the economic activities of society vary greatly in volume from time to time, and the demand for credit varies correspondingly. The arrival of "pay day" may cause a great industrial concern to call upon its bank for a hundred thousand dollars in cash with which to meet its payroll. The first day of every month, or the first few days of the month, will ordinarily witness the payment of literally millions of "book accounts" or other obligations that have been running for some weeks. Bankers in agricultural areas are expected to "carry" their customers during certain parts of the year by lending to them until their crops have been harvested and sold. Large amounts of credit must be available, not throughout the entire year but at certain times, to "move" the corn crop, the wheat crop, and other farm products that run into hundreds of millions of dollars. Manufacturers must be financed so that they may pay for labor, power, and raw materials while engaged in making seasonal goods for, let us say, the Easter trade or the Christmas rush. Finally, there are years of depression when but little credit is used, and years of business boom when credit facilities may be strained to the limit.

It is clear, then, that a supply of credit that is adequate for financing business at certain times may be quite insufficient for other times. Hence, there is need for an elasticity of credit that will meet the requirements of legitimate business under varying conditions, whether the quantity of credit demanded is large or small.

The Process of Rediscounting.—The Federal Reserve Act undertook to provide elasticity of credit through the agency of the rediscounting process. We have noted that Federal Reserve banks are often spoken of as "bankers' banks," and that this title arose in large part from the fact that the relationship between a Reserve bank and its member banks is much the same as that which exists between a member bank and its customers. Probably nowhere is this parallel relationship seen more clearly than in the handling of commercial paper; for the *discounting* of commercial paper, which is one of the most important functions performed by a member bank for its customers, is matched by the *rediscounting* of this same commercial paper, which is one of the chief services rendered by a Reserve bank to its member banks.

Business men ask their banks to discount commercial paper for them

when they must secure cash or increase their bank deposits in order to meet their obligations. Member banks ask the Reserve banks to rediscount commercial paper (that is, to discount again the paper which the member banks have already discounted for their customers) when they, the member banks, must secure cash with which to meet an emergency, or cash or increased balances with the Reserve banks which will enable them to extend further loans to their customers. However, throughout our discussion of rediscounting, the reader should bear in mind a provision in the Glass-Steagall Act of 1933 which reads as follows: "Discounting at Federal Reserve banks is definitely made a privilege, rather than a right, in that 'shall' is changed to 'may' in the phrase 'shall discount for members.'" From this provision it is clear that a Reserve bank has the power to limit its extension of credit to member banks.

Rediscounting to Increase Legal Reserves.—It will be recalled that a member bank must maintain with the Federal Reserve bank of its district a reserve of 13, 10, or 7 per cent (changed to 26, 20, and 14 per cent as of October 1, 1941) against the demand deposits of its customers. In depositing these reserves, the member banks acquire claims against the Reserve banks. Whenever their deposits with the Reserve banks are larger than are needed to fulfill their legal reserve requirements, member banks may withdraw the excess portion of their balances. For example, a "country bank" which owed its customers \$100,000 in the form of demand deposits would have to maintain a reserve of \$7000 (or 7 per cent) with its Reserve bank; but if these demand deposits were reduced to \$50,000, the bank could withdraw \$3500 of its deposit with the Reserve bank and still leave a sufficient balance to fulfill the legal reserve requirements. If, on the other hand, this bank wished to increase the demand deposits of its customers from \$100,000 to \$200,000, it would be required also to increase its reserves (that is, its balance with the Reserve bank) from \$7000 to \$14,000. It could do this by borrowing from the Reserve banks in much the same manner as business men borrow from member banks.

This process of borrowing by business men, as was emphasized earlier in the chapter, usually takes the form of discounting commercial paper. That is to say, the bank lends credit in the form of a bank deposit, accepting as security for the payment of the loan some sort of acceptable credit instrument. The process of rediscounting consists of a member bank taking this instrument to a Reserve bank and asking the Reserve bank to accept it as security for a loan to the member bank. In this way, commercial paper of approved types is made to do double service, forming the basis, first, of a loan from the member bank to a customer, and, later, of another loan from the Federal Reserve bank to the member bank.

The only commercial paper that is regularly eligible for rediscount is

short-term credit instruments which relate to actual business transactions. We have here a provision which indicates that the Federal Reserve System is designed to facilitate the extension of commercial credit and not investment credit. Short-term paper is defined as paper which matures within ninety days, but agricultural paper is acceptable if it does not run beyond nine months. Furthermore, no paper is eligible for rediscount if it has arisen from transactions in stocks or bonds. Since the rediscounting process requires endorsement by the member bank, all rediscounted instruments are "double-name paper."⁸

Not only does eligible commercial paper result from actual business transactions, but the need for credit expansion also arises out of such transactions. And so it happens that just at the time when business is brisk, with requests for more and more credit coming in to the banks, there is being created also a large quantity of commercial paper that can be exchanged, so to speak, for the desired credit. For the member banks can have this paper rediscounted at the Federal Reserve banks and thus increase their balances; and on the strength of these enlarged balances, which serve as legal reserves, they are entitled to extend further credit to their customers in the form of bank deposits. In this way an expansion of credit is made possible when it is most needed. But it should be noted that this use of the rediscounting privilege is regarded as distinctly an emergency measure.

As a safeguard against the undue expansion of bank deposits, the Federal Reserve banks, as well as member banks, are required to set up legal reserves against the claims of depositors as represented in demand deposits. Back of every deposit extended to a member bank by a Federal Reserve bank, the Reserve bank must maintain a 100 per cent reserve, of which at least 35 per cent must be in the form of gold certificates or other lawful money, and the remainder in commercial paper. A further safeguard against excessive expansion is the interest charge made by Federal Reserve banks on all loans that are due from member banks. Since the only way to escape the payment of interest is to pay off the loan, there is every incentive for member banks to redeem their commercial paper pledges as promptly as possible. When business men no longer need large amounts of credit and hence reduce their indebtedness to their banks, these banks in turn are likely to reduce their loans from the Reserve banks in order to effect a saving in interest.

An Illustration of Elasticity of Credit.—Since a reserve of only 35 per cent in gold certificates or lawful money is required (in addition to commercial paper) as security against deposit accounts in Federal Reserve

⁸ It should be noted that emergency banking legislation of the post-1929 depression period conferred temporary eligibility upon several other types of paper, which were to be discounted, however, only "in unusual and exigent circumstances."

banks, a gold dollar in a Reserve bank⁹ may be used as the basis of a \$2.85 credit on deposit. Consequently, a \$1.00 gold certificate in the possession of a Reserve bank will enable that bank to extend to member banks \$2.85 in credit; and member banks as a whole, in turn, will be able to extend a much greater amount of deposit currency to their customers. For the \$2.85 on deposit with the Reserve bank serves as a reserve, and is sufficient security to enable the member bank to give credit to the amount of approximately \$22.00, \$28.50, or \$41.00, depending upon whether the institution is a central reserve city bank, reserve city bank, or country bank. For \$2.85 is 13 per cent, 10 per cent, and 7 per cent, respectively, of the three amounts that we have mentioned. (This calculation is based upon the reserve requirements prior to August 15, 1936, which have since been changed several times, as we have explained.)

The case may be stated in a slightly different way. If a business man wished to borrow \$28.50 from a reserve city member bank, the bank would have to increase its reserve with the Federal Reserve bank to the extent of 10 per cent of this loan, or \$2.85. And the Reserve bank would need only \$1.00 in gold, plus \$1.85 in eligible commercial paper, to enable it legally to credit the member bank's account with this reserve of \$2.85.

Of course, the expansion of credit that actually takes place is not so great as we have imagined in our illustration. Indeed, it has been shown that the necessity for keeping on hand sufficient cash to meet the demands that may be made by depositors makes it impossible to extend anything like so large an amount of credit as we have suggested above would be legally permissible.¹⁰ Generalizations in such matters are risky, and because of their inexactness are often worthless; but our example of the maximum expansibility shows that gold under the Federal Reserve System is much more useful as a reserve than as a direct medium of exchange. However, it is a principle of Federal Reserve policy "that reserve funds should be used (either paid out or as a basis for credit) whenever they are genuinely needed, but should not be used beyond that need. The determination of what are genuine needs is a major problem."¹¹

Rediscounting to Secure Federal Reserve Notes.—The ability of member banks to increase their loans to customers depends not only upon enlarging their balances with the Reserve banks and thus gaining the privilege of expanding the volume of demand deposits, but also upon having sufficient "till money," or ready money, with which to cash the checks which customers write against their deposit accounts. Here, again, is a

⁹ As we have explained, the gold itself is actually held in the Treasury, and Reserve banks hold gold certificates which are virtually "warehouse receipts," but are redeemable in gold only at the discretion of the Secretary of the Treasury.

¹⁰ See, in this connection, C. A. Phillips, *Bank Credit*, New York, The Macmillan Company, 1921, chap. 3.

¹¹ W. R. Burgess, *The Reserve Banks and the Money Market*, p. 29.

financial problem for which the Federal Reserve System has provided a solution.

Just as the business man looks to his bank to supply money with which to meet his payrolls, so the member bank turns to its Reserve bank when in need of ready cash to hand out over the counter. This need, like the need for larger reserves, may be met through the process of rediscounting. When a member bank presents acceptable commercial paper to the Reserve bank, it may ask either for an addition to its deposit account, in the manner that we have described, or for immediate funds in the form of Federal Reserve notes. If its supply of till money is unduly depleted, it will doubtless choose the notes, which will be readily accepted by its customers when they present checks against their deposits.

Long before the inception of the Federal Reserve System, it was recognized that the inflexibility of bank note issue was a serious handicap. In times of industrial boom, when prices are mounting and business is expanding, there is a demand not only for more credit but for more actual money. Even more vital is the ability to secure funds when the boom has reached its peak, when there are anxiety and uncertainty in the air, and credit has been strained to the utmost. If the banks cannot lend aid in the face of such a crisis, bankruptcy may easily be the fate of business men whose assets are ample but unhappily are not sufficiently liquid to enable them to meet the pressing obligations of the moment.

Why could not the banks, in a situation such as this, have extended further credit to their customers? Because, first of all, bank deposits would already have been stretched just as far as possible in view of the necessity of maintaining legal reserves against deposit accounts; and because, in the second place, the conditions of *national* bank note issue were such that *this* form of credit could not readily be expanded in time of emergency. For the banking laws relating to these issues demanded that national bank notes be secured by a 100 per cent deposit of government bonds, plus a redemption fund of 5 per cent in lawful money. Therefore, a shortage of government bonds might have proved to be a very real stumbling block at a time when more bank notes were needed. For the government bonds that could be used as backing for note issues were limited in number, and most of them, as a rule, were already serving as security for issues of bank notes.

The Federal Reserve solution of this problem was to substitute commercial paper for government bonds as security against notes issued to meet the demands of business expansion. We are referring, of course, to the issuance of Federal Reserve notes through the process of rediscounting. When the member bank presents eligible commercial paper for rediscount and asks for Federal Reserve notes, the Reserve bank must deliver as security to the Federal Reserve Agent (who is the official rep-

representative, in the Federal Reserve bank, of the Board of Governors) gold certificates to the amount of 40 per cent of the issue, plus at least 60 per cent in the form of acceptable commercial paper. In addition to this collateral fund of 100 per cent, Federal Reserve notes are backed by the assets of the issuing bank, and their payment is guaranteed by the United States government. Consequently, elasticity of bank notes has been attained through the rediscounting process without any reduction in safety.

There is a tendency for Federal Reserve notes to move back to the bank of issue once the need for them has passed. When currency is again abundant and the member bank has more bank notes available than are necessary to meet the needs of its customers, it ordinarily returns as promptly as possible the Federal Reserve notes that it has borrowed, thus putting a stop to the interest charge. Member banks, being profit-seeking organizations, aim to keep in their immediate possession only such money as will be needed to satisfy the requirements of those with whom they transact business. Any surplus that they may have is sent to the Reserve bank, where it can be used to cancel loans or to serve as a legal reserve.

The rediscounting process is "a very present help in trouble," such as a bank faces when its depositors start a "run" upon its resources. If the bank's total volume of deposits is large, so that it will need a great deal of money with which to pay the depositors, it should also have in its vaults a large quantity of commercial paper. If it has pursued a sound commercial banking policy, lending on short-term commercial paper arising out of actual business transactions, it will have an abundance of such paper and will experience no difficulty in rediscounting this paper, and obtaining Federal Reserve notes with which to pacify its depositors. Probably there is no better way to stop a bank run than to pay the claims of depositors not only readily, but even eagerly! More than one depositor has been paid off in full, only to fall in again at the end of the line and redeposit his entire receipts, once he has satisfied himself that his money could be had if he really wanted it. And more than one bank run has been stopped by the appearance on the scene of a Federal Reserve truck carrying bales of Federal Reserve notes. The rediscounting feature of the Reserve System has aided materially in lessening the terrors of a financial panic.

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1. What is "credit money"?
 2. Explain the distinction between *investment* credit and *commercial* credit.
 3. What two types of capital result from the creation of these two forms of credit? Explain.
 4. "When *properly endorsed*, a note becomes '*negotiable*.'" Explain the italicized terms.
 5. What is the process of "discounting"?

6. There are several forms of the "draft," but all are based on the same general principle. What is this principle?
7. What is "double-name paper"?
8. What are the chief functions of the commercial bank?
9. Explain the relationship between "loans and discounts" and "deposits."
10. What is "deposit currency"? Give a synonym for this term.
11. What is the quantitative relationship between "money in circulation" and "deposit currency" in the United States?
12. What is a "demand deposit"?
13. Describe ways in which a demand deposit may be created.
14. What are the regulations governing the issuance of deposit currency? Why are such regulations necessary?
15. Of what significance is the statement that "commercial banks deal mainly with *short-term* obligations"?
16. Describe the workings and state the purpose of the clearing house.
17. The transactions of the clearing house "are carried through with a surprisingly small transfer of actual money." Illustrate.
18. Explain the way in which the Federal Reserve banks facilitate the clearing of checks. What is meant by the word "clearing" as here employed?
19. What is the "gold settlement fund," and how is it used?
20. What two specific objectives led to the inauguration of the Federal Reserve System?
21. What is a Federal Reserve bank, and where are the Reserve banks located?
22. What is the significance of the statement that Federal Reserve banks are "bankers' banks"?
23. What is a "member bank," and how does a bank secure membership in the Federal Reserve System?
24. By whom are the Reserve banks owned, and by whom controlled?
25. Explain the suggestion that Federal Reserve banks are "semi-private, semi-public institutions."
26. To what extent are the commercial banking agencies of the country allied with the Federal Reserve System? Be specific.
27. Describe the organization of the Board of Governors of the Federal Reserve System, and enumerate and explain its powers.
28. What changes were made in the handling of bank reserves through the provisions of the Federal Reserve Act? What are the present reserve requirements for demand deposits and time deposits?
29. What was the purpose of changing the legal reserve requirements?
30. Why is there need for "elasticity of credit" in the banking system of the United States?
31. State concisely the nature of the process of "rediscounting."
32. Describe the rediscounting process when used for increasing legal reserves.
33. What are Federal Reserve notes?
34. What function are these notes supposed to perform?
35. How does the plan of issuance of these notes facilitate the performance of this function?
36. Describe in detail the method of providing a larger degree of elasticity of credit by expanding and contracting the issue of Federal Reserve notes.
37. In what respects, if at all, is the issuance of Federal Reserve notes superior to that of national bank notes in meeting the needs of a complicated industrial society?
38. How may the issuance of Federal Reserve notes be used advantageously in stopping a bank "run"?

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CHAPTER 34

SIGNIFICANT ISSUES IN COMMERCIAL BANKING

IN THE last chapter, we described the functions of commercial banking in our modern economy, and outlined the system which undertakes to perform these functions for the people of the United States. In the course of our examination, we saw that in several respects the system has failed to meet fully the banking needs of the country. We shall now inquire more closely into some of the problems of commercial banking as they appear today.

THE PROBLEM OF ELASTICITY

The Nature of Elasticity.—One essential characteristic of a sound commercial banking system is elasticity of currency and commercial credit. Perfect elasticity is unattainable unless the following three conditions are met: First, the amount of currency and commercial credit in use must be able to expand and contract. Second, the expansion and contraction of currency and commercial credit must be coordinated, *in point of time*, with the changing needs of business and economic activity in general. Finally, the *extent* of expansion and contraction must also be coordinated with these changing needs.

Under these conditions, money and commercial credit will be able to perform their legitimate function of facilitating the operation of economic activity. They will not be issued in ways and amounts that will raise general prices, stimulate business activity, increase profits, reduce real wages and labor's purchasing power, lead to overinvestment in plant and equipment, and otherwise bring about conditions which will later lead inevitably to business depression; nor will they be decreased so sharply as to precipitate business crisis, liquidation, and depression. Money and commercial credit are legitimate devices for avoiding the inconveniences of barter, and for facilitating business operations. But their issuance should not be allowed to affect the volume of these operations, or to cause instability in economic activities.

The Control of Money and Credit.—The elasticity of money and commercial credit has not worked perfectly under the Federal Reserve System, for only two of the essential conditions of elasticity have been met. In violation of the third condition, the extent of expansion and contrac-

tion has not been closely coordinated with the changing needs of business. The movements of the general price level and the violent fluctuations in the volume of economic activity, which have occurred since 1913, indicate a tendency for the total volume of money and credit to become overexpanded in some periods and overcontracted in others. Despite the powers vested in the System for credit control, the issuance and withdrawal of money and credit have sometimes been allowed to stimulate business artificially, and at other times have made for depression. In other words, money and credit have not been confined to their legitimate neutral rôle of facilitating exchange. These unhappy results are attributable in part to a lack of sufficient authority, and in part to conditions which are inherent in the administration of any system of credit control.

The Control of Rediscount Rates.—One of the powers originally granted the Federal Reserve System for controlling money and credit was authority to raise and lower the rediscount rate. When an undue expansion of credit seems imminent, the Reserve banks can raise their rediscount rates, with the approval of the Federal Reserve Board (now the Board of Governors of the Federal Reserve System). Such increases mean, in effect, an increase in the prices which member banks have to pay for additional money or credit—that is, for loans extended to the member banks on the basis of eligible commercial paper endorsed by them and pledged with the Federal Reserve banks. The results which are expected to follow changes in rediscount rates are quite clear in theory. Increases in rates make it more expensive than formerly for member banks to obtain credit from Reserve banks. It should follow that the member banks will charge their customers higher rates for additional commercial credit and that the customers will consequently limit their new loans, and extensions of old loans, to amounts which are absolutely essential. When this occurs, the expansion of credit will be checked. Similarly, lowering the rediscount rates when business is slack is supposed to make it easier for member banks and their customers to borrow, and thus encourages them to increase their loans.

The Effectiveness of Changes in Rediscount Rates.—In actual practice, however, raising and lowering the rediscount rates has not been an effective device for controlling the expansion and contraction of money and commercial credit. In the first place, a considerable expansion of credit sometimes gets under way without recourse to rediscounting by member banks, because they have large reserves idle at the beginning of a period of active business. In the second place, when a bank rediscounts in order to increase its reserves with a Federal Reserve bank, it acquires a greater lending power than appears on the surface. If a bank adds \$1000 to its reserve by rediscounting, it is enabled to lend much more than that sum to business men in the form of demand deposits, even if other mem-

its contraction. In periods of poor business, there is ordinarily little or no rediscounting, so that a lowering of rediscount rates means little. At such times, member banks are likely to lower their interest rates to business men in any case. The truth is that, in a period of declining business, enterprisers do not want to borrow from member banks for normal commercial credit purposes, and the banks are not anxious to lend. When a business man thinks he cannot make profits by using borrowed funds, he is unlikely to borrow even if the interest rate is only one per cent.

Open-market Operations.—The other major power originally given to the Federal Reserve System for controlling commercial credit is open-market operations. This device functions through the rediscount rate, though indirectly. When there is danger of commercial credit being over-expanded, the Federal Reserve banks may decide to sell, say, a billion dollars' worth of government bonds in the open market. These securities will be bought by business men, corporations, banks, and other financial institutions. Let us suppose, for the sake of simplicity, that they are all bought by business men who pay the Federal Reserve banks with checks against demand deposits in member banks. These checks will be charged by the Federal Reserve banks against the reserve accounts of the member banks. This will lower the legal reserves of the member banks by a billion dollars, and the demand deposits which they may legally carry for business men by roughly ten times this amount. Hence, the member banks will have to curtail credit or replenish their reserves by rediscounting at the Reserve banks. If they do the latter, they will find that they must pay higher rediscount rates than before. In this way, the open-market operations are intended to make the changes in rediscount rates effective. However, since open-market operations must work through changes in rediscount rates, they cannot be more effective in checking credit expansion than a change in the rediscount rate itself would be.

When business is slack, the purchase of securities in the open market by the Federal Reserve banks is expected to increase the reserves and idle funds of the member banks, and thus stimulate lending by these banks. Here, again, the open-market operation is not likely to be effective. If idle funds are thrust upon member banks through open-market operations, the banks will probably use them to reduce their debts and increase their liquidity, or to purchase government bonds, rather than to make new loans to business men.

Other Factors in Credit Control.—Changes in rediscount rates and open-market operations were, until recent years, the only means by which the Federal Reserve System could control the expansion and contraction of commercial credit, unless one includes the doubtful measures of persuasion and exhortation. However, even if the powers of control were adequate, there would remain the difficult matter of deciding just when

to use them. To determine precisely when the further issuance of money and credit would be unsafe, the officials in charge would have to possess almost superhuman knowledge and ability. And yet the controls must be applied at exactly the right time if they are to be effective and not restrain desirable business activity. Even if it were possible to determine exactly when control should be exercised, it would take great courage to adopt the necessary measures at that time, in the face of the economic, political, and international pressure which might be exerted by those who would be adversely affected.

Recent Additions to Control Powers.—In the Banking Acts of 1933 and 1935, changes were made in the organization of the Federal Reserve System and in its credit control powers. We have already noted that the Board of Governors of the Federal Reserve System (formerly called the Federal Reserve Board) now consists of seven members, who are appointed by the President of the United States with the approval of the Senate. In the Act of 1935, it was specified that Board members should serve terms of fourteen years each at the salary of \$15,000 per annum, that their terms should expire in rotation, and that members could not be reappointed. These changes were intended to increase the independence and detachment of the Board, and to enable it to exercise its powers, when necessary, without fear of outside influence.

Increased powers were also granted the Board of Governors of the System. This Board now constitutes a majority of the membership of the Federal Open-Market Committee, and can control its decisions. Formerly this Committee of twelve was elected to represent the twelve Federal Reserve banks. Today, only five of the twelve represent these banks. Moreover, the decisions of the Committee to engage or not engage in open-market operations are now binding on the Reserve banks. These banks must submit their proposed rediscount rates to the Board of Governors at least once in every two-week period, and the rates must be approved by the Board before they become effective. This gives the Board of Governors control, for all practical purposes, over the rediscount rates charged by the Federal Reserve banks.

In addition to being given direct authority over rediscount rates and open-market operations, the Board has received other new powers for controlling commercial credit. First, it may now increase the reserve requirements that member banks must hold against demand and time deposits, by any amount up to double the long-established requirements of 13, 10, and 7 per cent (3 per cent for time deposits) for the three classes of member banks. The Board exercised this power by doubling these requirements temporarily, as of May 1, 1937; reduced them to 22½, 17½, and 12 per cent as of April 16, 1938; and raised them again, as of October 1, 1941, to 26, 20, and 14 per cent. Doubling the reserve requirements had the effect of reducing by one-half the ability of member

banks to extend demand deposits to business men on the basis of a given amount of reserves.

The Board of Governors may fix, for each Federal Reserve district, the percentage of a member bank's capital and surplus which may be extended to borrowers in the form of loans secured by stock and bond collateral. This percentage may be changed upon ten days' notice. After investigation and hearing, the Board may deny the credit facilities of the System to any member bank which appears to be lending too extensively for speculation in securities, real estate, or commodities. This power permits the Board to refuse rediscounting facilities for speculative purposes, while allowing credit to be expanded for normal business operations. Through its control over "margin" requirements, the Board also determines the percentage of the market values of securities that member banks may lend. Finally, the Board may suspend or remove any officer or director of a Federal Reserve bank, or of member banks, for continued violations of law, or unsafe and unsound banking practices.

These changes have greatly strengthened the control of the Federal Reserve System over the expansion of commercial credit. If the Board of Governors should decide to raise rediscount rates and to engage in open-market operations, and at the same time should raise to the limit the legal reserves for demand deposits of member banks, adjust margin requirements and the use of bank credit for speculative purposes, and cut off rediscounting facilities for erring member banks, it should be able to halt a movement toward the overexpansion of credit *in any ordinary situation*. Whether even these devices for credit control will be effective in a situation in which the gold reserves of the country and the excess reserves are very large—they were about 20 billions and 6 billions, respectively, in 1941—and the spending policy of the federal government is resulting indirectly in a continued growth of deposits, remains to be seen. It is not at all certain that the Board's control over the contraction of credit has been strengthened by recent legislation, though it may be argued that, if expansion can be controlled, the problem of regulating contraction will be greatly simplified. In any case, it remains true that credit control must be exercised wisely and courageously if desirable ends are to be reached.

THE PROBLEM OF SAFETY

In the last chapter, we saw that national banks were unable to provide adequate safety for depositors under the National Bank Act. The reserve requirements behind deposits were large, but each bank had to depend upon its own resources in time of trouble. There was no central agency to supply additional funds when depositors became impatient, and no process of rediscounting through which funds could be obtained. Moreover, a bank would often have trouble in bringing its own reserves into

banking practices which would not be tolerated in a member bank. Their reserves are not kept in accordance with the provisions of the Federal Reserve Act, but need comply only with those of state banking laws. In many cases their capitalization is smaller than the minimum required of a member bank, and the supervision to which they are subjected is often in no way comparable to that prescribed for member banks. The Federal Reserve System has no control over non-member banks, and has no authority to extend aid to them when they are in distress.

The Causes of Member Bank Failures.—In spite of the relatively favorable safety record of member banks in the depression years following 1929, many people feel that altogether too many member banks failed during this period. For 2110 bank failures form a heavy casualty list for a system which aims to provide safety for depositors; and the failure of these member banks tied up deposits running into billions of dollars. We may well ask how it happened that so many member banks failed. The answer is that the causes were many and various, running all the way from the use of funds to construct a modern replica of a Greek temple as the bank's place of business, to the "borrowing" of large sums by bank officials (sometimes without even the formality of giving a promissory note) and the loss of these funds in playing the stock market. However, the causes of many member bank failures were to be found in changes which took place in the nature of the loans and investments handled by these banks between 1921 and 1929. The figures in Table 36 will help to make these changes clear.

TABLE 36.—LOANS AND INVESTMENTS OF ALL MEMBER BANKS, 1921-1929³
(All figures in millions)

Year (June 30)	Investments	Loans on Securities	Loans on Real Estate	All Other Loans	Total Loans and Investments
1921.....	\$ 6,002	\$ 4,400	\$ 875	\$12,844	\$24,121
1922.....	7,017	4,500	1,100	11,565	24,182
1923.....	7,767	4,950	1,350	12,450	26,507
1924.....	7,963	5,350	1,575	12,279	27,167
1925.....	8,863	6,718	1,875	12,062	29,518
1926.....	9,123	7,321	2,161	12,579	31,184
1927.....	9,818	8,156	2,449	12,333	32,756
1928.....	10,758	9,068	2,624	12,611	35,061
1929.....	10,052	10,095	2,750	12,814	35,711
Percentage increase, 1921-1929.....	67	129	214	0	48

³ Source: *Hearings, S. Res. 71, 71st Congress, 3rd Session*, p. 138, as reported by Lawrence W. Towle in his article, "Time Deposits and Price Stability," in *American Economic Review* for December, 1935, pp. 653-660.

As may be seen from this table, one type of loan seems to have been slighted during this period of rapidly expanding loans and investments. "All other loans," which include all ordinary commercial loans to business men based upon short-term, self-liquidating paper arising out of the exchange of commodities, remained virtually constant during the period. It may be that the speeding-up of delivery services made it possible for some business men to reduce their inventory requirements and adopt the policy of so-called hand-to-mouth buying; and perhaps other firms were reluctant to become heavily indebted to commercial banks while the bitter experiences of the 1921-22 depression were still fresh in their minds. Then, too, as the period wore on, it is possible that their own large profits provided many business men with an adequate supply of funds and that "favorable" stock market conditions induced some corporations to obtain, by the sale of additional shares of stock, funds which would ordinarily have been borrowed from the banks. Whatever the specific causes may have been, it is an undeniable fact that, despite a 48 per cent increase in total loans and investments, the member banks were performing their principal function of providing short-term *business* credit no more briskly at the end of the period than at the beginning.

But during this period large additions were made to the gold stocks of the country, bank reserves were plentiful, and the Federal Reserve System, for various reasons, quite consistently followed an "easy money" policy. Since banking is not a profitable business unless bank funds are kept at work, the member banks, in the absence of appeals for ordinary commercial loans, decided to lend in other fields. The identity of these fields may be readily established by reference to Table 36. From 1921 to 1929, member banks increased their loans on real estate by 214 per cent, their loans on stocks and bonds by 129 per cent, and their direct security purchases and other investments by 67 per cent. As a result of these changes, many member banks found themselves by 1929 in a position which raised doubts of their soundness as commercial banks.

The Question of Frozen Assets.—We are not suggesting that loans should not be made on real estate and securities, or that banks should not invest in securities. Such loans are necessary and desirable, but we question that commercial banks are the best institutions to handle these kinds of business. When, during a boom period in business, commercial banks get the greater part of their assets tied up in real estate and securities, despite the fact that their depositors have the right to demand their deposits in cash either immediately or on a few days' notice, they are likely to find themselves in trouble if prosperity gives way to depression. For example, the depression years of 1929 to 1933 were marked by falling prices of securities and real estate, and many member banks were unable to recover the funds which they had lent or invested.

Of course, the member banks' "call loans" to brokers, secured by stocks and bonds, were in the main safe; and loans to other customers, advanced to buy securities, probably led to few losses when these loans were made on adequate "margin." For if the customers failed to pay their indebtedness, the banks could usually sell the securities for enough to cover the loans. However, some losses were doubtless taken on loans of this type, when bankers had imprudently lent too high a percentage of the inflated values of securities—for the slump in security prices was sudden and drastic. In many cases, the loans on real estate, which had seemed very conservative on the basis of the inflated valuation of the properties, were found to be uncollectible, for the depression prices of many parcels of real estate were less than the amounts that had been lent on them. Similarly, the banks' directly owned securities and other investments declined rapidly in value, and the efforts of distressed banks to liquidate these investments speeded the decline. Consequently, when depositors began to demand their deposits, member banks found themselves in serious difficulties.

But were not the Reserve banks expected, in such troublous times, to come to the rescue of their members? It was, indeed, a time when aid was needed, but the member banks were often not in a position to claim and receive aid. For membership in the Federal Reserve System was never an absolute guaranty of safety for a bank. The statement that the System would not allow member banks to fail meant merely that the Reserve banks would place funds, in practically unlimited amounts, at the disposal of member banks which had not impaired their borrowing power through dishonest or imprudent banking practices, and which had on hand a supply of collateral eligible for rediscounting. The Reserve banks could advance funds to members (1) by rediscounting eligible commercial paper, and (2) by discounting promissory notes of the member banks themselves, when secured by government bonds.

However, eligible commercial paper and government bonds are likely to be scarce in the case of banks that have lent extensively on other types of collateral. The Reserve banks could not legally rediscount paper based on stocks and bonds, or real estate mortgages; nor could they lend on the member banks' direct investments, unless these took the form of government bonds. So far as we know, no member bank failed during the depression because the Reserve banks were short of funds, but many failed because their assets were such that the Reserve banks could not legally aid them. And it developed that some member banks were signing their own death warrants when they overexpanded certain types of loans and investments from 1921 to 1929, though at the time they seemed merely to be sharing in what many people regarded as a new and permanent era of prosperity.

The Attitude of the Public.—It would be both unfair and misleading to say that every member bank that failed richly deserved to do so. The

banks that took improperly secured mortgages, and unseasoned, high-yield, narrow-market bonds, or that made loans on securities which were inadequately margined, inadequately diversified, or which otherwise failed to measure up to sound banking standards, were responsible for their own fate.⁴ Moreover, the conditions were even less satisfactory in non-member banks. However, some banks failed, or were at least seriously embarrassed, because of hysteria on the part of the banking public, and not because they were unsafe. Some banks that had been reasonably prudent were forced to close their doors because unreasoning fear on the part of their depositors led them to demand immediate cash for their deposits. And in some cases these demands could not be met because the banks had, in all good faith, accepted commercial paper which proved later to be worthless, since the firms that issued it had been forced into bankruptcy by the depression. It would seem, then, that a banking system is not much stronger than its weakest bank. Had not the failure of certain large banks disclosed the existence of unsound conditions in the banking world, the depositors of other banks might not have questioned the safety of their deposits, and thus runs on essentially sound banks might have been avoided.

Recent Legislative Changes Affecting Safety: Separation of Commercial and Investment Banking.—In view of the general criticism of our commercial banking system in recent years, it was inevitable that legislative steps should be taken to remedy the situation. Let us examine this legislation, considering first the measures taken to separate investment and commercial banking.

The Banking Act of 1933 provided that member banks must give up their security affiliates within one year. These affiliates were companies organized and controlled by commercial banks for the purpose of engaging in investment banking operations. These operations, which had proved very profitable prior to 1929, could not legally be performed directly by member banks. Though the relations of commercial banks with their security affiliates were often entirely wholesome and aboveboard, there were cases in which the reverse was true. The affiliates sometimes unloaded doubtful securities on the commercial banks—securities which the banks would not have purchased from anyone else—and the banks sometimes made loans to their affiliates in amounts and on securities which would not have been considered by the directors of independent banks. Hence, the separation of the two types of banking was probably necessary, if we are to have a sound commercial banking system. It was also provided that investment bankers shall not be allowed to hold demand deposits, and that no officer or director of a member bank shall be an officer or director of an investment banking firm.

⁴ So said Winthrop W. Aldrich, noted New York banker, in suggesting ways of improving the banking system, before the Sub-Committee of the United States Senate Committee on Banking and Currency at Washington, November 29, 1933.

We must also emphasize, at this point, the fact that the Board of Governors of the System has authority to regulate the percentage of member banks' capital and surplus which may be tied up in security loans, and may deny rediscounting facilities to member banks which misbehave in this respect. Formerly, the Reserve banks were required to rediscount for member banks whenever eligible paper was presented, and the member banks could use the funds for speculative or other purposes. Member banks are now prohibited from making call loans "for others"—the others being individuals, corporations, or foreign groups who wish their funds to be used temporarily for speculative purposes with the privilege of withdrawing them at any time. Member banks may not underwrite securities, may deal in securities only as agents of their customers, and may not have more than 10 per cent of their own capital and surplus invested in the securities of any one obligor.

Loans to Officers.—One of the evils of our banking system in the past was borrowing by executive officers from their own banks on collateral of doubtful value. The Act of 1933 provides that officers of member banks may not borrow from their own banks and must report any personal loans from other banks. However, according to the Act of 1935, banks may lend to officers of member banks in amounts up to \$2500, provided the loans have received the prior approval of a majority of the directors of the lending banks.

These regulations are probably desirable and, if they have the effect of keeping member banks within their legitimate field of commercial banking, may add to the safety of their depositors. However, it must be remembered that the effect of such legislation, with respect to both elasticity and safety, may be offset in part by the non-member banks, which are not controlled by federal legislation. Moreover, there may be other ways to render the regulations ineffective. For example, prior to 1933, a business man who wished to play the stock market might leave his own funds in his business as capital and speculate with borrowed funds. Now, however, he might speculate with his own funds and borrow from a commercial bank to finance the short-time needs of his business. In such cases, the banks' safety may be increased, but speculation is not controlled.

Changes in Member Bank Borrowing.—The Banking Acts of 1933 and 1935 also changed the terms on which member banks may borrow from Reserve banks, and provided a system of federal deposit insurance for bank depositors. During the depression, depositors were sometimes unable to get cash on demand, because of the inability of the banks to turn their assets into cash promptly. The obvious remedy was to make all kinds of commercial paper eligible for rediscount at the Federal Reserve banks. The new law did not do this, but it did something almost as unwise, for it provided that member banks may borrow from Reserve

banks on their own promissory notes, secured in any way satisfactory to the Reserve banks. These loans may be made for four months or less at a rate of interest only one-half of one per cent higher than the highest rediscount rate in effect at the Reserve banks. This means that, while only eligible paper may be rediscounted, member banks may, in effect, turn their ineligible paper and other assets into cash at Reserve banks and may thus be protected from the logical results of their unsound policies in lending on real estate and securities, and investing directly in securities. This policy may give greater safety to depositors, but it is extremely doubtful that it will raise the standards of commercial banking.

Loans on Real Estate.—The Act of 1935 also lowered the restrictions on real estate loans by member banks. These loans could formerly be made up to a total equal to 25 per cent of a bank's unimpaired capital and surplus, or 50 per cent of its savings deposits, whichever was greater; whereas the new limit is 100 per cent of capital and surplus, or 60 per cent of time and savings deposits, whichever is greater. The individual loans could formerly be made only up to 50 per cent of the value of the real estate, and for five years or less. Now they may be made for ten years and up to 60 per cent of the appraisal value, provided 40 per cent of the principal of the loan is paid in installments over the ten-year period. Moreover, such loans are renewable.

These new provisions relating to borrowing by member banks from Reserve banks and to real estate loans appear to us to be objectionable, though they have been hailed with evident delight by some writers on banking. These writers hold that investments and loans on real estate and securities have become an increasingly important part of the commercial banks' business in recent years and that, under the circumstances, it is silly to deny the banks access to the reserves of the System merely because they cannot supply the prescribed eligible commercial paper. If depositors are to be safe, the banks must be able to convert other assets into cash at the Reserve banks in an emergency. This is comparable to saying that commercial bankers must be allowed to wander into fields where they do not belong, but that the Reserve System must protect them against getting into trouble during their wanderings and thus causing loss to others. If the premise is granted, the conclusion seems to follow; but we suggest rather that an attempt should be made to keep commercial banks strictly within the field of commercial banking, and thus prevent the mistakes which are largely responsible for the losses suffered by depositors. If commercial bankers will only run their businesses as they should, they may obtain adequate assistance from the Federal Reserve System in time of need, under the old provisions for rediscounting.

The Plan for Deposit Insurance.—But if banks fail in spite of all that is done for them, the Act of 1935 has yet another safeguard for the deposi-

tors—for the Act provides for federal insurance of bank deposits through the Federal Deposit Insurance Corporation (hereafter referred to as the F.D.I.C.), whose original capital was furnished by the government and the Federal Reserve banks. All banks which were insured under a temporary plan provided by the Act of 1933 may continue to be insured. Member banks are required, and non-member banks permitted, to take out deposit insurance. New national banks and state member banks must qualify for insurance before receiving their charters, and non-member banks not already insured may be granted insurance after passing an examination. The F.D.I.C. may deny insurance to any bank it considers unsound or unnecessary, and banks may withdraw from the insurance system at will, or may be excluded for violation of rules. By the end of 1938, or after five years of operation, the F.D.I.C. was insuring the deposits of 13,709 commercial banks, or about 94 per cent of the total. The insured banks had more than 60,000,000 deposit accounts, and total deposits of about \$50,000,000,000.⁵

The F.D.I.C. provides insurance for each depositor of an insured bank up to \$5000. Persons having larger funds may secure full coverage by depositing with several banks. Despite the seemingly low limit of \$5000 per depositor, it has been estimated that 98.4 per cent of all depositors' accounts *by number* are fully covered by insurance, though only 43.5 per cent of all deposits *by value* are similarly protected.⁶ For this deposit insurance, the banks pay a premium of one-twelfth of one per cent per annum on total net deposits. If an insured bank fails, the F.D.I.C. may act as receiver and take care of the depositors by giving them deposits in a new bank organized for the purpose, or may pay them off in any other manner. It is more economical, as a rule, for the F.D.I.C. to organize a new bank, since most of a distressed bank's depositors are usually willing to leave their funds on deposit in a new bank, instead of asking for payment in cash.

Evaluation of Deposit Insurance.—Deposit insurance may be criticized from several angles. From a technical point of view, it may be questioned whether it is wise to provide insurance at a flat premium for all banks without regard to the risk involved. In other types of insurance, the principle employed is to vary premiums as between classes or individuals, according to the degrees of risk represented. Moreover, a flat premium rate based on total deposits seems to discriminate in favor of small banks; for a small bank may get practically complete coverage of its deposits by paying the flat premium on total deposits, while a large bank with many deposits over \$5000 may have only a fraction of its total deposits covered by insurance although it pays a premium based on total deposits. This discrimination is not necessarily undesirable.

⁵ *Annual Report of the Federal Deposit Insurance Corporation*, 1938, p. 9.

⁶ *Ibid.*, p. 80.

Furthermore, there is some doubt that bank deposits are genuinely insurable. Our experience in the post-1929 depression showed that a considerable number of banks may get into trouble at one time, and if this should happen in the future the F.D.I.C. might have serious financial difficulties. It is argued that a risk, to be really insurable, must be one which will not result unfavorably for many or most of the insured at any given time. Fire insurance companies would hesitate to grant insurance if there were any likelihood that all or most of the insured properties would be destroyed by fire at any one time. A popular answer to this objection is that depositors will no longer take part in runs on banks, since they know that the government stands behind the deposits, but this answer is not wholly convincing. In spite of the protection provided by insurance, the deposits in a bank that fails will not be available for depositors the next day, or even the next week. Some little time, and possibly several months, will elapse before all depositors will be paid. Since this is true, the desire to have one's money now rather than in several months may lead to bank runs as in the past, and cause the F.D.I.C. real embarrassment. If necessary, the government would doubtless provide the corporation with additional funds to prevent its failure; but if the need for such governmental aid should develop, the "insurance" of deposits, as such, would appear to be unsound. It is entirely possible that bank deposits could be handled through the application of the accepted principles of insurance, by carefully selecting the banks whose deposits are to be insured and charging premiums adapted to the risks, but many people have had doubts about our present system of insurance. Again, deposit insurance—especially insurance on a flat-rate basis—has been objected to on the ground that it may encourage recklessness on the part of some bankers, since they know that, because of the insurance, their actions will not cause loss to their depositors.

Quite apart from these criticisms, it is appropriate to ask whether deposit insurance of some kind is or is not a necessary and desirable adjunct of a sound system of commercial banking. Our answer is in the negative, and the basis of this answer is a familiar one. If we were to assume that commercial bankers through unsound banking practices would continue, in the future as in the past, to get into difficulties which would result in serious loss to their depositors, then we should be inclined to endorse federal deposit insurance. But we object to this assumption, since we contend that the depositors in a soundly conducted system of commercial banking would be adequately protected, in general, without recourse to government assistance in this form. Hence, we cannot regard deposit insurance as the best possible method of safeguarding the interests of depositors.

On the other hand, many arguments have been advanced in favor of deposit insurance. It is said to be costless to the banks themselves. The

argument is that the banks lose heavily whenever business men and other depositors lose their confidence in them, as they do after a period of bank failures, so that to buy insurance is cheaper than not to have it. It is believed that deposit insurance will stimulate the growth of savings deposits and prevent hoarding, and will aid in protecting sound banks against the runs which are common when weak banks fail. Finally, attention is frequently called to the helplessness of the depositors in the absence of insurance; to the inadequacy of the protection which they receive through governmental supervision and examination of banks; to the public character of banking; and to its great importance in our national economic life, which makes it imperative to avoid bank panics if it is at all possible to do so.

The Results of Deposit Insurance.—The fears that have been expressed about our system of deposit insurance have not been realized up to the present time, and the record of the F.D.I.C. has been favorable. In five years of operation, the F.D.I.C. paid out or set aside for payment some \$74,000,000 "in connection with the failure or rehabilitation of 252 insolvent or hazardous banks." For these banks, the deposit insurance covered 99.85 per cent of the depositors and 96.4 per cent of the deposits. The F.D.I.C. estimates that only \$21,000,000 out of the \$74,000,000, or 28 per cent, should be considered a total loss. The total expenditures of the corporation, including these final losses, amounted to \$36,000,000 in this period. The premiums paid by the insured banks brought in \$124,000,000 and the corporation received \$43,000,000 as investment income, so that the total income exceeded total expenses by \$131,000,000 over this period, and the surplus of the F.D.I.C. was increased by this amount.⁷

It also appears that the F.D.I.C. may be a strong force making for better banking standards in our system. It has the right to examine all insured banks, or to review the examinations of these banks. It actually examines all insured banks which do not belong to the Federal Reserve System, but it leaves the examination of national banks to the Comptroller of the Currency, and that of state member banks to the Board of Governors of the Federal Reserve System. It "cites" insured banks for violations of laws and regulations and for unsafe and unsound practices, and can terminate their insurance if they do not improve their behavior. Non-insured banks which desire insurance as non-member banks, insured non-member banks which wish to retire or reduce their capital or to establish or relocate branches, and insured banks of any kind which seek to assume the deposits of, or merge or consolidate with, non-insured banks, must obtain permission from the F.D.I.C. The F.D.I.C. has power to regulate the rate of interest paid by insured banks on time deposits, and banks are no longer permitted to pay interest on demand deposits.

⁷ *Ibid.*, pp. 3-10.

Finally, the operation of deposit insurance probably deters would-be bankers from starting unsound and unnecessary banks, since such banks may be refused deposit insurance and few people will care to intrust their deposits to banks that do not carry insurance of this kind.

THE NEED FOR FURTHER CHANGES

With safety for depositors already achieved, the chief problem of commercial banking in the United States is adequate control over the expansion and contraction of bank credit. Some students of banking problems question that such control is possible so long as we have a separate system of commercial banking for each state, side by side with the Federal Reserve System for member banks all over the country. With forty-eight state banking systems, each operating under its own banking laws, and with the state-chartered banks at least partly beyond the reach of federal control, effective regulation of commercial banking as a whole is most difficult of achievement.

Compulsory Membership in the Federal Reserve System.—From this point of view, the first step in genuine reform is to require every commercial bank in the United States to join the Federal Reserve System. This requirement would probably bring all commercial banks under one general plan, with the result that our national banking laws and regulations relating to elasticity, credit control, the relations of commercial and investment banking, and safety, would function much more effectively than in the past. It is important that this measure be enforced without any lowering of requirements, especially with regard to minimum capitalization for member banks. Indeed, it would probably be well to raise the minimum capitalization to a figure substantially above the present requirement. It may be objected that some state banks could not make the changes necessary to meet the requirements for membership in the Federal Reserve System. This is probably true; but the objection may be answered by saying that any bank which, given due notice, fails to measure up to the membership requirements is not an essential part of our commercial banking system and may well be eliminated.

Branch Banking.—Many economists feel that, even if all commercial banks were members of the Federal Reserve System, we could not adequately control bank credit so long as we have some 15,000 independent banks in the country. They believe our commercial banking problems would be simplified if we adopted a nation-wide system of branch banking, such as that of Canada or England. In England, the "big five" banks have some 8000 branches, and control about 90 per cent of the total banking resources of the country. In Canada, there are ten large banks with some 4000 branches.⁸ Under such a system, the United States might

⁸ Frederick A. Bradford, *Money and Banking*, New York, Longmans, Green and Company, 1939, p. 353.

have (say) ten or twenty large banks, each with hundreds of branches, and our present small independent banks would be eliminated. At present, branch banking is permitted only to a limited extent in this country. According to a recent report, we have 917 banks that have branches, and the branches number 3440, most of them being in the same city or county as the parent bank.⁹

In support of branch banking, it is urged that a large bank with many branches could have a widespread industrial and geographical diversification of assets and liabilities, which would prevent its being forced into bankruptcy by local factors affecting certain types of loans, while its size would make it possible to bear heavy losses without becoming insolvent. Many of our recent bank failures have been those of banks with very small capital which have been unable to diversify their loans properly and have become insolvent when their principal form of loans turned out badly. Under branch banking, it is claimed, such loans could safely be made by the branches, because these loans would be combined with many other types of loans and the parent institutions would be so large that whatever losses occurred could be absorbed without serious difficulty.

A second reason for expecting a reduction in bank failures is that branch banking would probably provide what are now our smaller banks with a superior type of bank management. The great size of the parent banks would make it possible to employ the best of management, and all branches would benefit by this high-class managerial ability. In addition, it might be possible to require bankers to be carefully and completely trained before they were placed in positions of responsibility.

The claims for branch banking advanced thus far have dealt chiefly with safety, and the problem of safety has already been largely solved in the United States. However, it would be desirable to have a system in which safety results from the *inherent soundness* of the commercial banks. It seems improbable that branch banking would bring a significant change in the *ability* of money and credit to expand and contract. However, the *control* of elasticity might be somewhat more effective than under our present system. It might be easier to induce a few large banks to cooperate in the control of credit than to get cooperation from thousands of more or less independent banks; and, furthermore, the enforcement of banking laws and regulations might be simplified under branch banking. Of course, the problem of proper examination of the banks and their branches would still be a formidable one.

On the other hand, it is possible that the higher type of management under branch banking might be offset to some extent by the heavy cost of the central organization, the red tape involved in its operation, delays in making decisions, and an extensive division of responsibility. A system

⁹ C. L. Prather, *Money and Banking*, Chicago, Richard D. Irwin, Inc., 1940, p. 328.

of branch banking might retard the economic development of the country. Small depositors and borrowers might be neglected because of the greater profitability of large accounts and the inability of small borrowers to furnish collateral security acceptable under the rules of the parent bank. Branch banks might find it difficult to adapt themselves to changing economic conditions. Large institutions often depend extensively upon formal rules and regulations in operating their business, and branch banking might result in a relative fixity of policy which would lessen the ability of the banking system to adapt itself to the varying needs of different sections of the country.

Finally, it is sometimes contended that branch banking might lead to a concentration of power which we would find intolerable. Those in control of the few great banks might come into control of industry, and dominate fiscal and Federal Reserve policies as well. Since the branch banks would be operated for profit, such a financial monopoly might adjust the issuance of commercial credit to the needs of the country even less successfully than our banking system has done in the past, and conceivably create a situation in which the banks would be safe only because of their ultimate reliance upon the credit of the government.

In attempting to reach a decision on the desirability of branch banking, the crux of the whole matter seems to be whether the management of banking institutions would automatically be better under branch banking than under our present system of unit banking. Unless bank management improved, merely the large size of banks would be no positive guaranty of safety. Large banks with many branches *could* diversify their loans and investments to a greater extent than ordinary independent banks, but there is hardly certainty that they *would actually and automatically do so*. Countries with branch banking have had failures of banks with hundreds of branches, though in general the banking record of such countries in the great depression after 1929 was excellent. Of course, parent banks in America might be so large that the government could not afford to let them fail; but this type of safety would represent no advance over the present situation, for we have already decided that we cannot leave our independent banks free to fail.

We can scarcely deny that the excellent results obtained in other countries with branch banking systems have been largely due to superior bank management, but we are uncertain as to whether the better management has been the result of branch banking *per se* or whether it has resulted from the development, through the years, of an established tradition of sound banking plus the operation of all banks under a unified banking system and uniform laws. In Canada, for example, all commercial banks operate under a set of laws applying to the whole Dominion. Canadian commercial banks do not lend on real estate or engage in handling trust funds. They may not hold shares of bank stock,

or make loans with such stocks as security. Their investments consist almost wholly of high-grade bonds or other securities which are quickly convertible into cash. Nor do they follow the common American practice of renewing a given short-term loan over and over again, until it amounts virtually to a fixed capital investment. Finally, the managers of Canadian banks are generally steeped in the principles of sound commercial banking, and have often risen from the ranks on the basis of merit alone. Such conditions might result in sound commercial banking in any country, whether or not it had a system of branch banking.

According to the supporters of branch banking, such superior management, practices, and policies *result from* having branch banking. If this conclusion is valid, it follows that the United States should proceed to develop a complete system of branch banking as rapidly and enthusiastically as possible.

The Limitation of Commercial Banking.—A vital need of banking in this country is an effective means for restricting commercial banks to the business of commercial banking. We believe that commercial banks should be forbidden to lend on real estate, for this is hardly a proper function of commercial banking. Loans on stocks and bonds should be permitted but sparingly, and then only with large margins of safety. The security investments of commercial banks should be limited to the highest and most liquid types of securities. The banks' power to make *fixed capital* loans to business men, by repeatedly renewing short-term *commercial* loans, should also be restricted sharply. Many of these types of loans and investments, which should not be made by strictly commercial banks, are appropriate for savings banks or for the savings departments of other banks; but, unless our commercial banks can learn to run their savings departments without becoming confused as to function, it would seem desirable for commercial and savings banks to be entirely separate institutions. This comment is applicable also to trust departments now operated by commercial banks.

Under conditions such as these, there would probably be little need for deposit insurance, or for member banks to borrow from Reserve banks on the basis of so many types of security. We should no longer be troubled by an extension of deposit credit to many times the amount of money available for the conversion of deposits into cash. If the deposits of commercial banks were almost entirely the result of bringing cash items to the banks or discounting eligible commercial paper, there would be no need to have on hand, in the form of money, 100 per cent of the deposits which might have to be paid off at any time. That is, if the banks' deposits were backed almost wholly by liquid investments and by commercial paper eligible for rediscount, the banks could always secure cash at the Federal Reserve banks in quantities sufficient to stave off any run by depositors; and we should not need to liberalize the conditions for

rediscounting or provide deposit insurance. The deposits of a *sound* commercial banking system are safe without outside guaranty.

The Development of Better Bankers.—Perhaps our greatest need in American commercial banking is better bankers, rather than better banking laws and regulations. Many an authority on banking, wearied by the adoption of countless banking laws which appear to bring little improvement, has suggested that our commercial banking system has been overburdened with legislation but insufficiently governed by sound credit policies and practices on the part of bankers. The American attitude toward banking problems has been that, if we could pass large numbers of good laws, we should get good banking; but actual experience gives ample grounds for suspecting that it is difficult, if not impossible, to make good bankers by legislation. We have tried, by laws and regulations, to prevent banking practices which bankers in other countries, under the influence of tradition and custom, would regard as unthinkable even in the absence of laws and regulations.

No body of banking laws can be so nearly perfect that bankers cannot, if they wish, find loopholes for employing methods which may eventually have serious consequences to their own businesses and to other members of society. If banking is to remain in private hands, there is no adequate substitute for the sound judgment of bank officers as a safeguard against the improper use of credit; and it seems clear from past experience that an improvement in banking personnel must be an integral part of any advance in commercial banking. There is need for an understanding of the relation of commercial credit to the rest of our economic structure, and an appreciation of the fact that a loan may be sound and profitable in and of itself and yet, in conjunction with thousands of similar loans by other banks, disastrous for the system as a whole. It was once the custom in a certain European country for the head of a wrecked bank to take his own life, instead of hiring a battery of lawyers to defend him or departing posthaste for foreign and sunnier climes. Without going so far as to advocate such harsh measures, we are firmly convinced that our bankers must be made to recognize their obligations—that they must be brought to regard banking as a kind of public trust instead of, or at least as well as, a business conducted for private profit.

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1. What conditions must be fulfilled if elasticity of money and commercial credit is to be attained?
 2. "The function of money and credit is to facilitate but not to determine the nature and content of economic activity." Explain.
 3. How was the Federal Reserve System, under the powers originally granted it, expected to control the expansion and contraction of credit?
 4. Were the powers vested in the System adequate for this purpose?

5. "Open-market operations and changes in rediscount rates are really only different phases of a single method of credit control." Explain.
6. How have the powers of the Federal Reserve System for controlling the expansion of commercial credit been strengthened in recent years?
7. Explain the importance of the Board of Governors' power to alter the reserves required behind the demand and time deposits of member banks.
8. Give some idea of the number of failures of member and non-member banks in recent years.
9. What was the leading cause of member bank failures in the depression years of 1929-33?
10. Recent banking legislation is said to have provided for the separation of commercial and investment banking. What is the meaning of this statement?
11. How did the Banking Act of 1935 change the terms on which member banks may borrow from Federal Reserve banks? Explain.
12. Explain the federal plan to insure the deposits of commercial banks under the Banking Act of 1935.
13. What problems arise in connection with a plan of deposit insurance such as we now have in the United States? Explain.
14. Is deposit insurance a necessary and desirable feature of a sound commercial banking system? Why or why not?
15. What other changes affecting the safety of depositors were included in recent banking laws? Explain.
16. Why do banking laws and regulations for credit control affect also the safety of depositors?
17. Should all commercial banks be required to become members of the Federal Reserve System? Explain.
18. Present the arguments for and against branch banking as a solution of our banking problems in the United States.
19. "A national system of branch banking should be adopted in the United States." Discuss.
20. Should we require that commercial banks limit themselves strictly to commercial banking? Explain.
21. "Even the best of banking legislation will not necessarily give us a sound system of commercial banking." What more is needed, and why?

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CHAPTER 35

INVESTMENT BANKING

AN INCREASE in population usually means an increase in economic machinery to supply the newcomers with commodities and services. An increase in individual purchasing power, permitting the use, by those in the lower income groups, of comforts or minor luxuries which have been denied them in the past, likewise leads to an expansion in productive facilities. Finally, every new invention of a practical nature—such as the automobile, air conditioning, or television—means the construction of buildings and equipment that will promptly place the new good in the hands of all who are able and willing to buy. Hence, in all economically progressive countries there is a continual demand for fresh supplies of fixed capital with which to increase the output of economic goods.

THE NATURE OF INVESTMENT BANKING

Funds to be expended for fixed capital may be, and sometimes are, provided by the business enterprisers who use them; and, again, they may be procured by enterprisers directly from private individuals who are looking for investments which they expect to pay them a satisfactory return from year to year. But financing of this kind—directly from saver to enterpriser—is likely to be on a rather small scale, and to relate to the individual proprietorship or partnership form of business organization. Also, in instances of direct borrowing the enterpriser is often personally acquainted with those who intrust their funds to him.

Investment Bankers.—It is much more common, however, to handle loans for fixed capital through banking houses that make a specialty of dispensing credit for permanent investments. Because of the need for agencies of this kind in a rapidly growing industrial society, there have developed in the United States a number of investment banking concerns, whose job it is to gather together the savings of many individuals and place them at the disposal of the few who can use them to advantage in the conduct of business ventures.

The process of collecting savings is carried on indirectly in most cases. That is to say, investment bankers do not as a rule come into direct contact with those whose funds they invest, unless the latter happen to be persons of great wealth whose accumulations are sufficiently extensive

to warrant individual attention. For the most part, the established investment banking houses secure their funds by offering for sale the stocks and bonds of concerns that are about to be launched, or of established concerns that can use to advantage additional quantities of fixed capital.

The "Selection" of Investments.—The process of financing a large business undertaking is far from simple. For convenience in discussion, the process is often divided into three parts—selection, underwriting, and distribution. If a group of business men should need to secure many millions of dollars' worth of capital for a new industrial project—say, the manufacture of plastics or television receiving sets—or should they wish to expand the plant or equipment of a going concern, they would be likely to open negotiations with a great investment banking house, such as J. P. Morgan and Company, or Kuhn, Loeb and Company, and request that this financial concern undertake to float an issue of stock or bonds, or perhaps both. If the banking house has no intimate knowledge of the project in question, it would undoubtedly make a careful investigation of all pertinent facts before agreeing to finance the operation. Of prime importance is the salability of the new securities, for investment bankers are seldom interested in buying stock and bonds which they cannot readily dispose of. But of almost equal importance is the safety of the project under consideration; for an investment banking house is known by the securities it sells, and its reputation is safe only as long as its customers are pleased with their purchases. Hence the need to ascertain that the business to be financed is entirely sound, and that its securities represent a safe as well as profitable investment.

Of course, not all businesses are financed through investment banking houses, but most of the "corporate securities" are put on the market with their assistance. The significance of new issues of corporate stock and bonds is indicated in Table 37, in which such issues are compared with total new issues of securities in the United States, not including those of the federal government.

"Underwriting" and "Distribution" of Securities.—If, with all necessary information at hand, the investment banking house decides to undertake the task of providing the desired funds, it guarantees (or "underwrites") the sale of the necessary stock or bonds, or both, within a specified time. The investment banker buys these securities from the company at a figure lower than the anticipated market price, so that he may reasonably expect to make a profit from their sale. Now comes the task of disposing of the securities. To this end, the investment house usually proceeds to form an "underwriting syndicate," a temporary association made up of a number of other investment houses that are given an opportunity to join in the sale of the securities in question.

Each of the several underwriting concerns guarantees that certain

TABLE 37.—NEW CAPITAL FUNDS RAISED BY SECURITY ISSUES IN THE UNITED STATES, 1930-1939

(Source: *Statistical Abstract of the United States, 1940, p. 308*)

	Total New Issues *	Total New Corporate Issues
1930.....	\$7,677,000,000	\$5,473,300,000
1931.....	4,022,900,000	2,589,000,000
1932.....	1,730,300,000	643,900,000
1933.....	1,053,700,000	381,600,000
1934.....	2,212,300,000	491,100,000
1935.....	4,752,300,000	2,267,400,000
1936.....	6,254,300,000	4,631,900,000
1937.....	4,001,300,000	2,433,700,000
1938.....	4,457,900,000	2,139,200,000
1939.....	5,836,700,000	2,178,900,000

* Including foreign and domestic corporations, foreign government issues, farm loan issues, state, municipal and territorial issues, but not issues of the United States government.

amounts of the securities will actually be sold. The original banking house now offers these securities for sale to the public at, of course, a higher price than was paid for them. If the entire issue is sold without difficulty, each of the participating concerns is rewarded on the basis of the quantity that it individually underwrote, or guaranteed. If, on the other hand, some of the securities remain unsold after a specified time, they are divided among the underwriting houses in proportion to their guaranties, and are sold by each to investors on terms as advantageous as can be secured.

Underwriting, it will be seen, involves the principle of insurance, and is one of the many devices used in the business world for "spreading the risk." An investment house would usually rather have a one-twelfth interest in each of a dozen good securities, than complete responsibility in a single stock or bond that has been issued in huge quantities.

Investment bankers are sometimes called "security merchants," the great banking houses that float issues of stocks and bonds being known as wholesalers and the smaller underwriting houses as retailers. The commercial banks also play an important part in the business of providing investment credit, since they lend extensively to investment banking houses, accepting as security for the payment of the loans the stocks or bonds that the underwriters have taken over from the Morgans, the Kuhn, Loeb, and other large issuing concerns.

Our organized security exchanges, such as the New York Stock Exchange and the New York Curb Exchange, are another agency in the

distribution of securities. As soon as an issue is listed on an exchange, the exchange becomes a market place in which the security may be bought and sold. The promoters of an issue sometimes manipulate the market in such a way as to cause a gradual rise in the price. This is done by offering to buy the security at progressively higher prices day by day. Thus, a stock that is being manipulated by a "pool" of bankers who are interested in disposing of large numbers of shares might sell today at \$30 a share, tomorrow at \$30.25, the next day at \$30.50, and so on. Certainly no shares will be sold at less than the price offered by the pool, since holders of shares will naturally sell, if at all, at the highest price obtainable. As the price keeps rising, the general public, noting the steady increase and scenting big future profits, is drawn into the market and this new demand for shares aids materially in distributing the issue. This is one of the shady practices prohibited by the Securities Exchange Act of 1934, which we shall examine later in the chapter.

Though not all of the securities issued through investment bankers are listed on the organized exchanges, the largest, most important issues are listed. At first, many of these stocks and bonds get largely into the hands of buyers who are speculatively inclined, and who are likely to sell out in a few weeks or months and pocket the gain to be realized through whatever price increase has taken place since the date of purchase. But once a stock or bond has become established as a dependable security paying a satisfactory return, it comes more and more extensively into the possession of investors, who buy primarily for the purpose of getting a steady income from their purchases.

Reinvested Earnings.—Another important means of accumulating funds for the purchase of fixed capital is the reinvestment of part of the earnings of business concerns. It is now a very common practice for great corporations not to distribute to their stockholders in the form of cash dividends as much as has been earned in a given period, say a year. Not only does the successful business enterprise usually establish a surplus fund from which to meet deficits and pay dividends in unprofitable years, but a part of the profits of good years is often laid aside with the deliberate intention of using it for expanding the business—that is, for providing fixed capital. The growth of the Ford Motor Car Company from an original investment of only \$28,000 to one measured in hundreds of millions was accomplished wholly through the device of reinvested earnings, no new capital funds having been added to the business except those withheld year by year from the tremendous earnings of this company.

While additions to new capital from reinvested earnings are not so large as the additions made through the sale of stocks and bonds, they nevertheless form a very significant part of the capital accumulations of this country. Of course, earnings that are allocated to surplus add to

the value of the business, and in the case of corporations are reflected in the enhanced value of the stock outstanding, provided no additional shares are issued. But boards of directors frequently issue stock dividends in lieu of cash dividends, and this action tends to hold down the selling price of the shares. On the other hand, it puts new shares in the hands of the old stockholders, who if they wish may convert their new holdings into cash by selling them to others. But whether the new shares are held or sold, the new capital funds which they represent are in the possession of the corporation. With the use of these funds, expansion may proceed without the delay and expense that might be entailed had the corporation attempted to secure these funds through the sale of stocks and bonds.

Agencies for the Collection of Savings.—By whom are industrial stocks and bonds purchased? Ultimately, of course, by the general public or by that portion of the public that earns more than it spends for consumptive purposes. But in most cases the savers of income do not invest it directly, but through an intermediate agency of one type or another. Commercial banks, savings banks, insurance companies, and endowed institutions of many kinds have funds to invest from time to time. Since these funds are not likely to be called for soon, or to any appreciable extent, they are largely available for long-time investment, provided the investment is safe.

Because many of these savings belong to persons of extremely limited financial resources, there is especial need for security; and certain institutions, such as insurance companies and savings banks, are restricted in the uses to which their available funds may be put. Though the individual investment in insurance or in a savings account is frequently small, the total accumulation of this kind is great. For example, savings accounts in this country had reached, by 1940, the imposing total of nearly 26 billion dollars, which represented the savings of some 45 million depositors.

It may be said, in conclusion, that approximately 15 per cent of the national income of the United States is saved every year. This means something like 15 billion dollars added to the total resources of the country in a "boom" year, and about half this amount in a year of moderate depression. A large part of these savings is used for permanent investment in fixed capital, and is handled through the investment banking process that we have sketched.

PROBLEMS OF INVESTMENT BANKING

Many problems of individual and social significance have arisen in connection with investment banking. One is the necessity of providing the greatest possible degree of safety for purchasers of the securities issued by investment banks. Investors must be protected from securities

that are fraudulent in character, and from security salesmen who grossly overstate the possibilities of the stocks and bonds they offer to the public.

Another important problem is to insure that investment banking shall be carried on efficiently and in a manner consistent with the public welfare. More specifically, this means that investment credit must not be so extended at certain times and so restricted at others that its issuance becomes an important cumulative factor in causing business instability. It means, also, that this credit must be distributed among the industries seeking it, so as to coordinate the creation of new productive facilities with the desires of consumers. Finally, it is important that investment banks, in performing their function, shall not be permitted to get a strangle-hold on industry by threatening to withhold needed credit if such control should be denied them.

Safety for Investors.—Those who have securities to sell are frequently more optimistic as to the future of their stocks and bonds than the situation warrants. Consequently, many of the securities sold to the public have turned out to be worthless. This failure of securities to live up to the representations of the sellers is by no means a new economic phenomenon. Indeed, it is as old as the corporation itself. The fleecing of the public through the sale of worthless securities has led to the adoption, by forty-three states and the District of Columbia, of laws regulating the sale of securities and, in some cases, providing for the recovery of losses incurred by those to whom they have been sold in violation of law.

But the widespread purchase of stocks and bonds in the boom period preceding 1929, followed by the loss of an estimated 25 billion dollars by the American purchasers of valueless securities, brought the question of investment frauds to a head. The result was the passage of two federal measures, the federal Securities Act and the federal Securities Exchange Act.

The Federal Securities Act.—The federal Securities Act was passed in 1933. Its purpose was "to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof."

Without intending to interfere in any way with the enforcement of state legislation dealing with the sale of securities, this federal law was designed to insure that the buyer of stocks and bonds should be fully informed as to the standing of the company in which he was investing. The issuer of a security was required to file with the Securities and Exchange Commission (a commission of seven members appointed by the President of the United States) a registration statement which contained all information about the security which an investor needed to know. Until this statement was filed, the security could not be sold or offered for sale through any agency of transportation or communication in interstate commerce or through the mails. Once the statement was filed, the

seller had to provide every buyer with a prospectus, which in reality was a summary of the information contained in the registration statement.

The Act also provided for the civil liability of security issuers to investors suffering losses, if the registration statement or prospectus contained false information or omitted material facts. All who shared in misleading the investors, including the issuing corporation, the original investment bank marketing the security, the underwriters, and even accountants and other experts, were held liable. As originally passed, the liability provisions were very severe. Purchasers of securities could recover in court their full losses on the securities, even though the false information or omissions in the registration statement or prospectus were not the cause of the loss, or were only a partial cause. The Act permitted recovery of losses by anyone buying a security, whether or not he ever saw or relied upon the statement containing the false information or omission. Each member of an underwriting syndicate was held liable to all purchasers of a security, including the customers of other members of the syndicate as well as its own customers, and suit could be brought for the recovery of losses at any time within ten years after the public offering of the security.

Appraisal of the Federal Securities Act.—The federal Securities Act aroused a good deal of protest. There was general sympathy with the aims and purposes of the Act, but it was felt that the law was unduly severe in prescribing liability for security issuers and sellers. It was held that the Act assumed guilt on the part of all connected with unfortunate security issues unless they could prove their innocence, and that it would foster litigation, false claims, and nuisance suits. It was pointed out that not all information connected with a business could be furnished to the Commission and that a fact, originally omitted from the registration statement as unimportant, might later appear to be material and relevant. Some critics even expressed a fear that the investment banking business might be practically exterminated because of the great dangers and liabilities that would have to be borne by corporations, investment bankers, and underwriters.

As a result of those protests, the federal Securities Exchange Act of 1934 amended the federal Securities Act in several respects. The purchasers of new securities may now recover full losses, without regard to causation, unless the defendant can establish that the loss was not caused, or was only partly caused, by the false information or omissions of the registration statement or prospectus. If a person buys a security before the publication of the first twelve-months' earnings statement of the issuing corporation after the date of registration, it is assumed that he relied on the information in the registration statement and prospectus. If the security is purchased later, reliance on the information must be proved. No member of an underwriting syndicate is now liable for an

amount in excess of the aggregate price of his share of a security issue, and a suit to recover a loss must be brought within three years after the public offering of the securities.

It is difficult to say just what effect the Securities Act has had on the volume of new security issues. To be sure, the investment banking business has been at a low ebb since the enactment of the law, as well as for several years prior to its enactment, and many opponents of the Act have attributed the small volume of business to a fear of the consequences of enforcement. But this theory does not account for the decline in railroad and municipal financing, since these fields do not come under the provisions of the Act. Moreover, there are other and more plausible explanations of the decline. It is possible that investment bankers have been "on strike" in an effort to make the law appear unworkable. Many industries had already overdeveloped their productive capacities and would not have been in the market for new financing in any case, while the officials of some corporations doubtless decided that their credit had deteriorated and were not anxious to assume the burden of further fixed charges. Monetary uncertainties and the lack of savings clamoring for investment may have been other factors entering into the situation.

In general, there seems to be no reason why the law, as amended, should unduly restrain the legitimate issuance of investment credit.¹ If well administered, it should be of considerable aid in providing safety for investors. However, further provisions of the Act may eventually require amendment. It is contended that the information which corporations must now supply is unreasonably voluminous. It would seem that adequate information could be obtained without a corporation having to furnish, as in the past, enough facts to fill ten to fifteen large bound volumes at an expense to the corporation of from \$150,000 to \$200,000. It is probable that suits under the Act should be heard only in the federal courts, and not in state courts as well. Finally, small underwriters should perhaps be allowed to rely on the statements of large investment houses, since it would be difficult for the small firms to insure that the data given for registration and prospectus are full and accurate.

The Securities Exchange Act.—The federal Securities Act was not adequate to protect all investors, however, for two reasons. First, it applied only to new security issues, and many investors lost their all by purchasing securities already existing on the exchanges. In the second place, while most bonds are publicly offered, many new issues of stock were formerly distributed through the security exchanges, often by manipula-

¹ But it does appear to have led to an increase in the number and percentage of security issues that are placed privately instead of being handled through investment banking houses. The private offerings of corporate securities mounted steadily from 1934 to 1939, totaling more than 700 million dollars and almost 33 per cent of total corporate security issues in 1939. Cf. E. S. Mead, *et al.*, *The Business Corporation*, New York, D. Appleton-Century Company, Inc., 1941, pp. 299. 300.

tive practices of the type cited earlier in the chapter. For example, when an issue of stock was to be distributed, the first step was to register it, say on the New York Stock Exchange. Then the owners of the issue would make it appear active on the exchange, by hiring brokers both to buy and to sell the issue for the account of the owners. For a time they might have to buy more than they sold, so that the price of the stock would show a steady rise. But eventually the public, attracted by the activity and price rise of the stock, would come into the market; and then the brokers, by selling more shares than they bought, could distribute the issue at the artificially high price.

The Securities Exchange Act, passed in 1934, aims to discourage such practices. Besides amending the federal Securities Act of 1933, as previously noted, it requires all security exchanges, unless exempted by the Securities and Exchange Commission, to be licensed by the Commission after furnishing certain required information. Every security issue listed on the exchanges must also be registered with the Commission by the issuing corporation. The registration statements must contain facts in ten categories enumerated by the Act, in addition to any further financial statements which the Commission may deem necessary. The corporations may also be asked to file certified reports periodically. The result is that many corporations are now required to register with and furnish information to the Commission, although they would have been exempt from such obligations under the federal Securities Act of 1933 because they have not recently attempted to issue new securities.

Control of Manipulative Practices.—The Securities Exchange Act attempts to define, or give the Commission power to define, the functions of brokers, dealers, and specialists, and forbids certain manipulative practices under penalty of \$10,000 fine and two years' imprisonment, or both. Under this Act, pools which are organized to make money by forcing the prices of certain securities up or down may no longer use publicity to advance their interests. They are prohibited from circulating false and misleading information about a security, from circulating any information, true or false, about prospective rises or falls in prices because of pool activity, and from paying anyone directly or indirectly for circulating such information. The creation of fictitious market activity is also forbidden. That is, it is now unlawful for any person, directly or indirectly, alone or with others, to effect a series of transactions in a registered security creating actual or apparent trading in such security or raising or depressing its price to induce purchase or sale by others. It is illegal to use the facilities of the exchanges, or of interstate commerce, or to use the United States mails for such purposes.

Corporate directors, officers, and stockholders who own 10 per cent or more of an issue of securities must file a statement with the Commission setting forth their holdings, and must report changes in ownership

during each month. If officers and directors buy and sell the securities of their own corporations within a six-month period and make a profit, the gain belongs to the corporation and may be recovered by legal action. Moreover, these officers and directors are not allowed to make "short sales" of the stocks of their corporations, in order to profit by declines in the prices of these securities. Short-selling, as a manipulative device, is brought under the Commission's control, to be regulated as it may deem advisable. It may require exchanges and exchange members to report short sales daily, and to report the coverage of short sales. "Pegging" the price of a security, through purchases by its sellers while the security is being marketed, is tolerated only under rules and regulations to be laid down by the Commission. Finally, the Board of Governors of the Federal Reserve System is given the power to control margin requirements for borrowing on securities.

Administration of the Act.—In general, the regulation of stock exchange practices and activities under this Act is not particularly strict. The Act is rather vague, and its strength lies chiefly in its wise interpretation by those who administer it. If the Act is wisely and fearlessly administered, it should be of considerable benefit. The regulation of trading activities is fairly closely in line with plans which the exchanges themselves have been slowly developing. Thus far, the Commission is admitted, even in financial circles, to have been quite reasonable and realistic in its interpretations and actions. It has left regulatory machinery in temporary form whenever it thought that additional factual material was necessary as the foundation of permanent policies, and has made clear that, within reasonable limits, the exchanges would be allowed to police themselves. It also prevented the removal of many securities from listing on the exchanges by permitting the temporary registration of securities until permanent registration could be arranged.

Opponents of the Act point out that it attempts to regulate some activities which are necessarily difficult to uncover and prove. Operating as a curb on speculation, the enforcement of the Act may make the market for securities "thin" and subject to sharp price changes in certain periods. It is alleged that a market with plenty of speculative activity is necessary if the exchanges are to function as continuous markets for securities—that is, markets in which securities may be quickly converted into cash at prices that measure their values accurately. Also, inactive markets are supposed to have a restraining effect upon the issuance of new securities. However, some observers are of the opinion that sharp swings in security prices are attributable to the activities of the speculators. It is very doubtful that real investors often need to buy or sell securities in large quantities on short notice, so that some of the alleged advantages of a speculative market are but slightly realized by those to whom they are popularly supposed to be of greatest benefit.

The Total Volume of Investment Credit.—While important steps have been taken in the direction of providing safety for investors, very little has been done about the other problems in the field of investment banking. One problem which must be faced in any economic system is that of the relative distribution of productive resources between (1) providing for present consumptive wants and (2) providing for the future through the production of capital goods. So long as productive methods remain the same and productive resources are scarce, we can enjoy a more abundant life in the future only at the expense of present consumption. The investment bankers play an important part in this situation, since the sale of security issues is the principal way of securing funds with which to buy fixed capital.

Unfortunately, however, the investment banking business is not stable, nor does it adjust itself easily to the changing demands of industrial society. Rather it operates by fits and starts. In times of business prosperity, investment credit flows in a veritable flood and often gets far in advance of current savings available for investment, since commercial banks frequently lend funds to customers so that they may acquire securities on the installment plan. Such periodic overextensions of investment credit are partly responsible for building up the business booms which in turn give way to depressions. At other times, the flow of investment credit dries up until it is a mere trickle.

Of course, the investment bankers are not wholly to blame for periods of over- and under-investment, much less for business booms and depressions. Indeed, we have already seen that they are middlemen in the investment process, acting in response to the demands of business for investment credit and the demands of individuals and institutions for securities. The bankers could scarcely market securities in dangerously large quantities unless corporations wanted huge amounts of investment credit and people could be found to buy the securities at such times. And security purchasers could not indulge their wild desire to get rich quick by buying stocks and bonds unless the commercial banks lent the funds necessary to finance these purchases. However, we know that the ability of investment bankers to control the total volume of investment credit is much greater than is commonly assumed.

Those who engage in business in our modern economic system find it necessary to forecast future economic conditions, such as the probable extent of markets and the prices of certain commodities. In days of prosperity, they become unduly optimistic and overestimate future earnings. This is as true of investment bankers as of business men in general. When business is good, profits are large, security prices are mounting, and the future demand for consumption goods and the facilities for producing them seem unlimited, it is easy for investment bankers to exaggerate the need for investment credit. And, unfortunately, their mistakes

may have wider and more serious repercussions than the mistakes of ordinary business men. It seems true, also, that the mistakes of investment bankers are more likely to arise from a desire for private profit than from attempts to gauge the needs of the country for productive facilities.

The Distribution of Investment Credit Among Industries.—Another problem in investment banking concerns the way in which these banks distribute investment credit among industries. Since the quantity of funds available in our economic society is not sufficient to finance all of the undertakings in which business men would like to engage, it is obvious that some enterprisers will get the funds that they want while others go without. And since most of our industrial financing today is done through the investment banking houses, it is equally obvious that our investment bankers exercise a large degree of control over production. In a very real sense, they hold the power of life and death over a large part of the productive activities of the economic world, since they are in a position to provide the funds that a given concern needs and insure its operation, or to veto its appeal and thus seal its doom.

The best interests of society require that whatever capital funds there are shall be dispensed in such a way as to promote the most essential industries—that is, those which will contribute most to the welfare of society as a whole. But it is doubtful that this end can be attained so long as the distribution of investment credit is left in the hands of profit-seeking individuals. Investment bankers are probably, on the whole, neither better nor worse than any other group of business men. But they certainly are not particularly well equipped, *from the point of view of society's needs*, to perform the function of granting or denying funds. They are trained in detecting money-making opportunities; and in deciding which economic undertakings are to be financed they are naturally attracted to those that give promise of paying large returns. Thus, funds might be directed by profit-seeking bankers into the construction of palaces for multimillionaires, leaving none available for the building of "model apartments" for working people, even though the millionaires were already magnificently housed and the workers were living in slums.

The Domination of Industry by Investment Bankers.—Investment bankers have often required, as a condition of issuing investment credit to a corporation, that the corporation appoint on its board of directors one or more members of the banking house, ostensibly for the purpose of insuring the safety of the security issue. This requirement appears innocent enough on the surface, but Americans in general were somewhat startled, some years ago, to learn that one investment house in this country, together with its dependents and allies, was represented by directorships in corporations with net assets of some 74 billion dollars, or about one-fourth of the total of American corporate assets. This power was centered in the hands of some 167 persons in the banking house, and they

held 2450 interlocking directorships in corporations.² It is difficult to say to what extent investment bankers control the policies of corporations at present, but certainly it would be socially undesirable for this control to develop so far that a small group of private persons, acting as investment bankers, could dominate the economic activities of the country.

A Possible Solution.—If the investment banking industry refuses to conduct itself in a manner consistent with the public interest, we shall probably be required eventually to choose between further regulation on the one hand, and government ownership and operation of investment banking on the other. Further regulation is, of course, the more conservative of the alternatives. But it is by no means clear that further regulation would help greatly. It might aid in preventing the domination of industries by investment bankers, but it is doubtful that regulation could prevent the recurrence of periods of over- and under-investment, or cause the bankers to distribute investment credit in accordance with social needs. Many people contend that these problems are insoluble so long as investment banking remains in the field of free enterprise and is conducted for profit.

The socialization of investment banking would involve many changes. Complete control over the issuance of investment securities would probably be vested in a government board created for the purpose. This board would presumably be appointed by the President of the United States. Its members would doubtless serve long terms, which would expire in rotation. They would be paid adequate salaries and be required to sever all private business connections. The board would control the total volume of investment credit, the distribution of credit among industries, and the rates of return, if any, which the securities issued would guarantee to investors.

In this way, it is claimed by some people, the problems which we have discussed would be solved. The board would regulate the total volume of investment credit in accordance with the needs of society, and would not be induced, by any considerations of profit or loss, to over-expand credit at certain times and limit it unduly at others. Its aim would be to distribute credit among the industries of the country so that those which needed further development would be expanded, while the others would be held in check—for the members of the board would have no private reasons for preferring one industry to another. Finally, the danger of domination of the country's economic activity by a small group of private bankers would be removed.

Criticism of the Plan.—But the control of investment credit by a government board would be a large undertaking. There are those who ques-

² H. W. Laidler, "Have We a Money Trust?" in *The World Tomorrow*, September, 1931, pp. 282-284.

tion that the government could control this phase of economic life effectively, while leaving certain other phases to run themselves as in the past. They fear that the extension of government control to investment banking would inevitably result in bringing many other types of economic activity under public ownership, until finally a socialist state would be created. They point with scorn to the records of governments in business, which they contend demonstrate the inefficiency of government operation. They hold that the issuance of investment credit would be backward, rather than progressive, so that new industries could not develop as at present, because of the government's unwillingness to assume risks. They say that the issuance of investment credit would be involved in red tape and subject to political control, and political "pull" would be used in obtaining desired funds.

Finally, the critics doubt that the problems of investment banking could be solved in this manner. A government board, like a private individual, may be too optimistic at certain times and too pessimistic at others, so that the issuance of investment credit might be marked by large cyclical swings as in the past. The problem of determining genuine needs for credit among the various industries would still be a difficult one, and mistakes would be made by a government board as well as by private bankers. Moreover, the board might come to dominate economic activity even more completely than our present bankers, so that we would be moving from one type of domination to another and worse type, according to these critics of public ownership.

These arguments are not wholly convincing. The criticism relating to political conditions and political control may have been valid in the past and may be so even at present, but the mere mention of the words "political control" scarcely constitutes an effective argument against the government going into business. So far as solving the problems of investment banking is concerned, no one would contend that a government board would perform perfectly the task of controlling investment credit. It might issue too much or too little credit at times, and would probably make many errors in estimating the needs of various industries for funds. However, we should at least have the consolation of knowing that these mistakes were made by representatives of society trying to adapt investment credit to social needs, rather than by private individuals seeking their own self-interest and guided only by the profit motive. And if economic activity must be at least partly controlled by an agency which issues investment credit, many people would doubtless prefer to have this control exercised by a group of men representing society as a whole, rather than by profit-seeking investment banking houses.

1. What is the function of the investment bank?
2. Explain what is meant by the "selection," "underwriting," and "distribution" of securities.
3. Show the way in which fixed capital is provided through the reinvestment of earnings.
4. What is the total volume of "savings accounts" in the United States?
5. What percentage of the national income may we expect to be saved in this country in times of business prosperity?
6. Explain how the problem of providing safety for security purchasers became acute in recent years. How did the federal Securities Act of 1933 undertake to provide this safety?
7. Criticize the federal Securities Act both constructively and destructively.
8. Why was additional legislation necessary for the protection of security purchasers? How is the Securities Exchange Act of 1934 supposed to be helpful in this connection?
9. What problem exists in connection with the total volume of investment credit issued by investment bankers? In what respects are the investment bankers themselves responsible for the existence of this difficulty?
10. It is "obvious that our investment bankers exercise a large degree of control over production." In what way?
11. Is there any danger that investment bankers may come to dominate the industries of the country? Explain.
12. Can the problems of investment banking be solved while this business remains in private hands?
13. What advantages and disadvantages do you see in connection with the control of investment credit by a governmental board, as is sometimes proposed? Explain.

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CHAPTER 36

PRICE LEVELS

THE STUDY of prices, as pursued by economists, follows two main lines of inquiry. The first of these seeks to explain the forces that determine the prices of individual commodities and services.¹ The second line of inquiry has to do with general, or average, prices. The general prices of one time are compared with the general prices of another time, and an effort is made to measure and explain any changes that may have taken place. The general prices of a given time—say, of the year 1942, or of a single month of that year—are frequently called a “price level.”

THE DETECTION AND MEASUREMENT OF PRICE LEVEL CHANGES

General prices at different times, say in two or more different years, may be compared through the use of a device known as the “index number.”

The Making of Price Index Numbers.—Index numbers of general prices are constructed by choosing a *base year*, in which general prices are given a rating of 100, and then giving to prices of other years ratings either higher or lower than 100, depending upon whether the prices of those years are higher or lower than the prices of the base year.

The principle of index numbers will be better understood if we consider a simple table and describe, with actual prices, the manner in which the index numbers are arrived at. Table 38 is made up of the prices of five commodities for the years 1926, 1920, and 1941. The prices here given are from wholesale quotations of those years. Wholesale prices are used because accurate wholesale quotations can be secured more readily than accurate retail prices, and, moreover, they vary less throughout the country than retail prices.

The year 1926 has been chosen as the base year. The individual prices of that year are added, and to this aggregate is given a rating of 100 per cent. The percentages for the other two years are arrived at by comparing the aggregate prices of those years with the aggregate for 1926. Dividing the aggregate for 1920 (\$1.79) by the aggregate for 1926 (\$1.55), and multiplying by 100, we get the index number of 115 for

¹ Individual prices were dealt with in vol. 1 (chaps. 12–17).

TABLE 38.—CONSTRUCTION OF UNWEIGHTED INDEX NUMBERS

The aggregate of the 1926 wholesale prices of five commodities being used as a base, the "relatives" (or percentages) for 1920 and 1941 are computed by dividing the aggregates of the latter years by the aggregate of the base year, and multiplying by 100. The results are the unweighted index numbers for these years. The method is called the "relative of aggregates."

Commodities	Prices per Unit		
	1926	1920	1941
Butter (per pound).....	.40	.67	.35
Eggs (per dozen).....	.30	.48	.33
Coffee (per pound).....	.58	.15	.13
Lead (per pound).....	.08	.09	.03
Cotton (per pound).....	.19	.40	.10
Aggregate Prices.....	\$1.55	\$1.79	\$.97
Unweighted Indexes.....	100	115	63

1920. In like manner we arrive at an index of 63 for 1941. The index number for 1926, the base year, is, of course, 100.

Weighted and Unweighted Index Numbers.—These three index numbers are "unweighted"; that is, the five commodities that we have used have affected the total index number in proportion to their *prices per unit*, and not in proportion to their relative importance in the total volume of the country's trade. But some items enter much more extensively into trade than others, and the large sales of such goods entitle them to special consideration in the construction of indexes. Consequently, it is now the custom to "weight" index numbers, multiplying the price of each commodity by a number indicating its relative importance in total trade, so that the part played by each item in influencing the final index number is determined by the quantity of that commodity that is bought and sold.

If we assume that the sales of butter, eggs, coffee, lead, and cotton amount to 20,000, 30,000, 10,000, 5,000, and 20,000 units, respectively, we may compute *weighted* index numbers which reflect more accurately than *unweighted* indexes the changes that have taken place in general purchasing power. These revised index numbers, as is shown in Table 39, are 100 for 1926, 140 for 1920, and 76 for 1941.

There are at least a half-dozen index numbers in this country that have been constructed with care and are being kept up to date. Professor Irving Fisher, of Yale University, publishes a weekly *commodity* index based on 120 items. Carl Snyder, of the Federal Reserve Bank of New York, for many years published a *general* index (discontinued in 1940) in which were included not only wholesale and retail commodities, but

TABLE 39.—CONSTRUCTION OF WEIGHTED INDEX NUMBERS

The individual prices are multiplied by the quantities sold. An aggregate of these total prices is found for each year, and the index numbers are arrived at by dividing each of these aggregates by the aggregate for the base year, and multiplying by 100. The results are weighted index numbers.

Commodities	Units Sold Annually	1926		1920		1941	
		Unit Price	Total Price	Unit Price	Total Price	Unit Price	Total Price
Butter (per pound)	20,000	.40	\$ 8,000	.67	\$13,400	.35	\$ 7,000
Eggs (per dozen)	30,000	.30	9,000	.48	14,400	.33	9,900
Coffee (per pound)	10,000	.58	5,800	.15	1,500	.13	1,300
Lead (per pound)	5,000	.08	400	.09	450	.06	300
Cotton (per pound)	20,000	.19	3,800	.40	8,000	.10	2,000
Aggregate Prices			\$27,000		\$37,750		\$20,500
Weighted Indexes			100		140		76

many other items. One of the best indexes of *wholesale commodity prices* is that published by the United States Bureau of Labor Statistics.

Snyder's General Price Index.—As we have noted, Carl Snyder's index of general prices included a wide variety of items. It was, indeed, an *index of indexes*, for Dr. Snyder computed his index numbers from twelve separate indexes compiled by government bureaus, the Federal Reserve Bank of New York, and several other agencies. The twelve types of prices that went into the making of this general index were security prices, composite wages, retail food prices, prices of equipment and machinery, farm prices at the farm, automobile prices, wholesale hardware prices, rents, realty values, other cost of living items, transportation costs, and industrial commodity prices at wholesale. Because it includes a wider variety of items than any other index of prices, this general price index is more nearly representative than any other of the "general price level," and on this account we shall employ it in discussing the purchasing power of money up to and including the year 1939.

Wholesale Commodity Price Index of the Bureau of Labor Statistics.—We must take time, however, to describe briefly the index of wholesale commodity prices to which we referred above. For many years the Bureau of Labor Statistics has compiled, month by month, an index of commodity prices, which is of importance not only because it is constructed with great care from a great many commodity prices, but also because it is cited so often in current newspaper and magazine articles. Probably no other index of prices is so widely used. It is now made up of the wholesale prices of 813 commodities; and these commodities include farm products, foods, hides and leather products, textiles, fuel and lighting, metal

and metal products, building materials, chemicals and drugs, house furnishings, and miscellaneous goods. The base year of the index has been changed from time to time as the Bureau has deemed desirable. At present, 1926 is the year on which the index is based.

The number of items entering into an index is not a matter of hard and fast rule. Some indexes include many items and others relatively few, but the exact number appears to be much less important than the exercise of care in choosing representative samples. Professor Fisher, who has written widely on the subject, suggests that an index that does not include more than 20 items is seldom of much value. He regards 50 items as a much more satisfactory number. "After 50, the improvement obtained from increasing the number of commodities is gradual and it is doubtful if the gain from increasing the number beyond 200 is ordinarily worth the extra trouble and expense."²

The index of the Bureau of Labor Statistics goes back as far as 1890, but the figures for years prior to 1926 are based on fewer commodities than are the figures since 1926; however, to quote an official statement of the Bureau, "they may be considered comparable for all practical purposes." This index, like that illustrated in Table 39, represents a "relative of aggregates"; moreover, all of the items that have been used, unlike those of Table 38, have been carefully weighted by multiplying individual prices by the quantities sold in each year.

General Prices and Purchasing Power.—In Table 40 are given the index numbers of general prices, of the purchasing power of the dollar, and of wholesale commodity prices, for the years from 1900 to 1940, inclusive. A comparison of Columns 1 and 2 shows that when the general price index is high the index of purchasing power is low, and vice versa. This is necessarily the case, since the index of purchasing power is obtained by dividing the general price index of the base year, 1926, by that of another year, and multiplying by 100. We see, then, that a United States dollar in 1911 bought 178 per cent as much as in 1926; but in 1920 it purchased only 88 per cent as much as in 1926. Judged by the 1926 standard, therefore, the purchasing power of the dollar was great in 1911, but small in 1920; and, judged by the same standard, the general price level was low (56) in 1911, and high (113) in 1920.

Curves of Index Numbers.—The general price index and the index of purchasing power for each of these forty-one years are plotted in Fig. 51, so that the price changes from year to year may be noted more readily.

The horizontal line indicated by the index number 100 shows the kind of price "curve" we would have had, had there been no changes in general prices during the period in question. The curve indicating the

² Irving Fisher, *The Making of Index Numbers*, Boston, Houghton Mifflin Company, 1922, p. 340.

TABLE 40.—INDEXES OF GENERAL PRICES, PURCHASING POWER OF THE DOLLAR, AND WHOLESALE COMMODITY PRICES, 1900 TO 1940

(Sources: Federal Reserve Bank of New York, and United States Bureau of Labor Statistics. Base year, 1926)

Year	General Price Index	Index of Purchasing Power	Wholesale Commodity Index
1900.....	44	227	56
1901.....	45	222	55
1902.....	46	217	59
1903.....	47	213	60
1904.....	47	213	60
1905.....	48	208	60
1906.....	50	200	62
1907.....	52	192	65
1908.....	52	192	63
1909.....	54	185	68
1910.....	56	178	70
1911.....	56	178	65
1912.....	58	172	69
1913.....	58	172	70
1914.....	58	172	68
1915.....	60	167	69
1916.....	68	147	85
1917.....	81	123	117
1918.....	92	109	131
1919.....	101	99	139
1920.....	113	88	154
1921.....	95	105	98
1922.....	92	109	97
1923.....	96	104	101
1924.....	97	103	98
1925.....	99	101	103
1926.....	100	100	100
1927.....	100	100	95
1928.....	103	97	98
1929.....	105	95	96
1930.....	98	102	86
1931.....	88	114	73
1932.....	76	131	65
1933.....	75	133	66
1934.....	79	126	75
1935.....	87	115	80
1936.....	90	111	81
1937.....	94	106	86
1938.....	90	111	79
1939.....	89	112	77
1940.....	^a	^a	79

^a Discontinued in 1940.

level of general prices which actually prevailed in these different years shows that from 1900 to 1915 general prices were fairly stable; that there was a sharp advance in general prices from 1915 to 1920, then a sudden fall to 1922; that from 1923 to 1930 general prices were again fairly stable, though on a much higher level than between 1900 and 1915; and that after 1930 there was a steady decline to 1933, followed by a slight upturn in 1934 which continued to 1937 but declined for two years

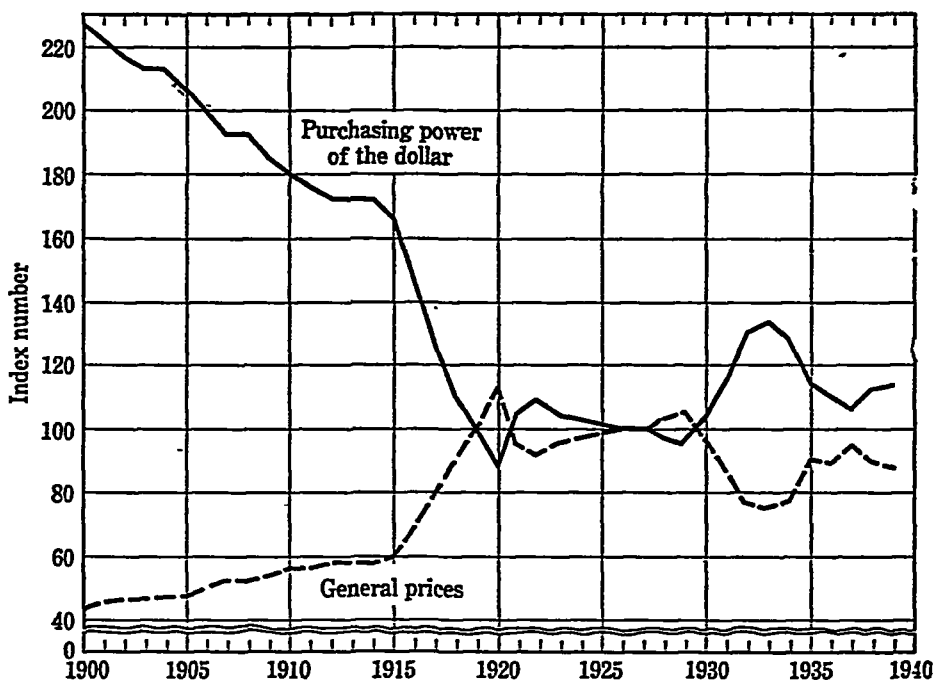


FIG. 51.—GENERAL PRICES AND PURCHASING POWER OF THE DOLLAR, 1900-1940
(See Table 40)

thereafter. The peak of prices was reached in 1920, when the general level of prices was about twice as high as before the first World War and consequently the purchasing power of the dollar was about half as great as in 1913.

Changes in the Value of Money.—We have noted that the index of purchasing power of the dollar varies inversely with the general price index. Whenever the latter is higher than 100, the former is lower than 100. This fact is shown graphically in Fig. 51. Every advance in general prices indicates a decline in the value of money, and vice versa. In 1920, for example, when the index of general prices was 113, the index of purchasing power was 88. This means that the value of the dollar was approximately nine-tenths as great in 1920 as in 1926. The index of purchasing power, then, is also an index of the value of money.

POSSIBLE CAUSES OF CHANGES IN PRICE LEVELS

Our reference to money in the preceding paragraph suggests that money may have something to do with changes in price levels. This relationship between money and general prices is set forth in the Quantity Theory of Money. The theory states that general prices tend to vary directly with the quantity of money—or, as some quantity theorists say, with the quantity of money and credit—in circulation. This means that if the quantity of money is increased, other things remaining unchanged, the price level will rise; and if the quantity of money is decreased, other things remaining unchanged, the price level will decline.

The Equation of Exchange.—The “other things” to which we have referred are (1) the velocity of circulation of money, and (2) the volume of trade. The velocity of circulation refers to the “rate of turnover” of money, or the number of times that it is used in a given period. We saw in an earlier chapter that money may have a turnover of twenty-five or thirty times a year; that is, the same dollar may be used in twenty-five or thirty purchases in a twelve-month period. The volume of trade relates to the total number of exchanges that take place in a given time; of course, an exchange is made every time a thing is bought or sold. With these facts in mind, we may set down a formula, which is known as the “equation of exchange,” from which we shall exclude “credit” for the present, but include it later. We assume for the moment, then, that all goods are paid for with money. The equation of exchange, under these simple conditions, would be stated thus: $P = \frac{MV}{T}$. In this formula, P

relates to the price level, M to the quantity of money, V to the velocity of circulation (or turnover) of money, and T to the volume of trade, or total number of exchanges. We have already noted that money is desired ordinarily not for its own sake, but almost exclusively because of its usefulness in buying economic goods. This being the case, it is probable that all of the goods that are offered for sale will exchange for all of the money that is available, since purchasers, in their desire to secure goods, will bid higher and yet higher prices for the goods they wish, until the limited quantity of money prevents further bids.

Our equation of exchange is merely a convenient way of expressing this fact, and what it says in effect is that, for a given period of time, prices in general are determined by the relationship between MV and T . It will be apparent, therefore, that any change in M or V , without a corresponding change in T , will cause a change in P . If, for example, the quantity of money (M) should increase, the other factors remaining constant, the price level will rise. An increase in the velocity of circulation (V), without change in the other factors, will have a similar effect. And if the volume of trade (T) should increase, without a corresponding

change in either the quantity of money or the velocity of circulation (or both), the price level will experience a decline. It is evident, then, that there is a relationship among these three factors, and that a change in any one, without some offsetting change in either one or both of the others, is bound to affect the price level. As Professor Cassel puts it, "The existing quantity of money must involve a definite performance of payments, to which the level of prices is obliged to adjust itself."³

Examples of the Equation of Exchange.—The possible effects upon the price level of changes in the quantity of money in circulation, the velocity of circulation, or the volume of trade, may be illustrated by several examples. Let us assume, in order to make our conditions very simple, that the total amount of money in circulation is \$5000; the velocity of circulation is 30; and the total trade is 150,000 "goods units," every goods unit being exactly like every other, and each consisting of 1/150,000 of the total quantity of every kind of economic goods entering into trade during the period under consideration.⁴ Under these conditions, the price of a goods unit may be ascertained by recourse to our formula. Substituting the known quantities for M, V, and T, we have the following equation:

$$P = \frac{\$5000 \times 30}{150,000}$$

The price of a goods unit, therefore, is \$1.00. Since a goods unit represents all kinds of goods, we may say that a unit of *goods in general* sells at this time for \$1.00; and by giving to this amount an index number of 100, we may compare prices at other times with prices at this time, provided we have specific figures to substitute for the symbols in the equation of exchange.

If we suppose, by way of illustration, that a year later the quantity of money was twice as great as in the above example, but that there had been no change in V or T, a simple calculation will show that the price of a goods unit would be \$2.00, and the index number 200; and if the quantity of money were to fall to \$2500, with no change taking place in the other factors, the price would necessarily drop to 50 cents, and the index number to 50.

If M and T were to remain constant at \$5000 and 150,000, respectively, while V (the velocity of circulation of money) changed from 30 to 15, we should again have a goods unit selling at 50 cents, and the index number of general prices would be 50. If M and V should remain con-

³ Gustav Cassel, *The Theory of Social Economy*, New York, Harcourt, Brace & Company, Inc., rev. ed., 1924, p. 426.

⁴ The assumption involves the supposed division of the whole of every kind of economic goods that is sold (both commodities and services) into 150,000 equal parts, and the combination of one fractional part of each of these items into a single unit, which we are calling a goods unit. Each goods unit would then consist of 1/150,000 of the total volume of trade, and would therefore represent not only all items but also the proportion to which every item entered into trade. Readers who are familiar with Professor Fisher's "goods dollar" or "commodity dollar" will note here a family resemblance to that well-known concept.

stant, while T increased to (say) 300,000 units, then once more the price per goods unit would be 50 cents, and the index number of general prices would be 50.

These simple calculations demonstrate that a change in P may be the result of a change in M, V, or T, or a combination of changes in these three factors of the equation. Because we assumed that the *total volume of trade* consisted of goods units, there can be no question that the prices about which we have been talking are *general prices*, or *price levels*. Since we took as a base the period in which a goods unit sold at \$1.00, we were justified in placing the index number for that period at 100; and from this point it would follow logically that the index for the second period (with a goods unit selling at \$2.00) would be 200, and the indexes for the remaining three periods must be 50.

"Credit" in the Equation of Exchange.—It is now necessary to make a modification in our equation of exchange as it has been described, since prices are affected not only by the quantity of *money* available for the purchase of goods, but by the quantity of *credit* as well. Indeed, credit plays a much greater part than money in influencing the price level, since the quantity of deposit currency available for the purchase of economic goods of various kinds is many times as great as the quantity of money actually in circulation. The general nature of the equation, however, remains unchanged. All that needs to be done is to insert two new factors, M' for credit, and V' for the velocity of turnover of credit. The formula, as revised, is as follows: $P = \frac{MV + M'V'}{T}$. If all the factors

of this equation except P are known, this unknown factor (representing the price level) may be ascertained just as readily as in the simpler form of the equation.

The Quantity Theory of Money.—It is obvious, therefore, that the changes in the price level are brought about through changes in one or more of these several factors. Unfortunately, it is not possible to say with great exactness to what extent these factors do change from time to time. It is the contention of a group known as the "quantity theorists" that the important changes in price levels result from changes in M and M', which are usually grouped together under the title, "circulating media." It will be recalled that there is a relationship, though not a very exact one, between money and credit, since credit, which exists chiefly in the form of deposit currency, is based upon money in the form of bank reserves; so that, within certain rather wide limits, the quantity of credit is fixed by the quantity of money.

The quantity theorists believe that changes in the velocity of circulation are not of sufficient importance to affect the price level greatly; that is to say, they are of the opinion that fluctuations in the velocity of circulation do not prevent the dollar from being employed just about as

general prices from 1900 to 1913. During this period the index number rose from 44 to 58, 1926 being used as the base year; and during this same period there was a steady increase in both money and credit, resulting from the increased production of gold which had its beginning in the latter years of the nineteenth century. Finally, an examination of money and bank deposits for 1929 and 1933 shows an *increase* of about a half billion dollars in the quantity of money during this period, but a *decrease* of eight billions in the volume of demand deposits. This substantial net decrease in total circulating media in the United States was accompanied by a decline in the price level from 105 to 75. To quantity theorists the concurrent decline in the price level and the volume of circulating media appears to suggest a causal relationship between the two, and to provide further confirmation of the soundness of the quantity theory of money.

However, what we have said about high general prices going hand in hand with a large total volume of circulating media, and low general prices with a small total volume of circulating media, must not be thought to constitute conclusive proof that the volume of money and credit is the *cause*, and the price level, high or low, the *effect*. Indeed, there are a good many economists of high standing who believe that the opposite is true, and that changes in the total volume of circulating media may be the result of changes in general prices—that it is changes in P that lead to changes in M and M' , and not the reverse. But it is safe to say that there are few, if any, who would deny that the general level of prices, P , is affected by changes in M and M' , provided all other factors in the equation of exchange remain fixed.

EFFECTS OF FLUCTUATIONS IN PRICE LEVELS

We may now examine briefly some of the results of changes in general prices. It should be remembered, first of all, that, barring transitional effects, it matters little whether prices are high or low. The equation of exchange shows that all goods entering into trade will exchange for all the money and credit in circulation. If, therefore, the quantity of circulating media of one period were double that of another period, with trade and velocity of circulation remaining unchanged, the price level would be just twice as high as it had been. Doubling the amount of circulating media, then, means a doubling of general prices, if V , V' , and T have not been affected; and it means also that a given standard of living now costs approximately \$6000 instead of \$3000, or \$20,000 instead of \$10,000.

But if this new price level should remain unchanged for a considerable length of time, wages and other forms of payment would also tend to be twice as high as they had been. We would then give twice as many dollars (or "counters") for a given amount of goods as were required to make the purchase prior to the increase in general prices; but no hardship would ensue, since wages and salaries would also consist of twice as

many dollars (or counters) as had been received before the rise in prices took place. We see, then, that it is the *transitional effects*—the results of sudden and extensive price fluctuations—that cause the trouble that is experienced on account of changes in price levels. High prices and low prices are equally harmless, if only one or the other, once adopted, will “stay put.” But changes in price levels may result in genuine hardship for some and unearned gains for others.

The Hazards of Long-time Credit.—These gains and losses are likely to occur whenever there is an extension of credit over a period of years during which changes in the price level occur. In lending or borrowing money, it is really purchasing power which is loaned or borrowed. If a business man had borrowed \$1000 in 1913 and repaid the loan in 1920, the amount of purchasing power returned to the creditor would have been 51 per cent of the amount received in 1913, and the creditor would have been the loser by \$490. If, on the other hand, this loan had been made in 1920 and returned in 1928, the borrower would have returned to the creditor \$1102 in purchasing power, instead of the original \$1000 borrowed, because of the decline in general prices. And if he had waited until 1933 to return the loan, he would have paid back \$1000 in money but more than one and one-half times as much purchasing power as he borrowed, since the \$1000 in 1933 would have bought about as much economic goods as \$1510 in 1920.

These simple illustrations show that debtors gain by paying their obligations when prices are high, and lose by paying when prices are low. Business men are borrowing all the time, sometimes to meet current expenses and again for the purpose of making additions to equipment. Changes in price levels may have serious consequences to such individuals if they happen to borrow when prices are high in order to make improvements, for, as we have seen above, they may have to repay the loans when prices are low, and this means that they must pay back more purchasing power than they received. Hence, creditors gain by reason of declines in the price level, *provided the fall in prices does not make it impossible for the debtors to make payment*. This proviso is important, for sudden and great fluctuations in price levels may make it impossible for debtors to meet their obligations, and force them into bankruptcy. In such event the creditors are, of course, far worse off than though the price level had remained unchanged, or had even risen so as to make the repayment of loans easy, in the manner described in the preceding paragraph.

The Problem of Fixed Money Income.—Sharp rises in price levels also have serious effects upon persons living on incomes from fixed money obligations. We may take the example of a retired business man living in 1913 on an annuity of \$6000. With prices as they were at that time, he could live quite comfortably on this amount. But in 1920 those same

6000 dollars would buy only as much economic goods as he could have secured in 1913 for \$3060, and his standard of living, of necessity, would have dropped accordingly. However, if he was still alive in 1933, he found that much of his lost purchasing power had come back. For his \$6000 in 1933 had 50 per cent more purchasing power than in 1920, since the index of purchasing power for 1933 was 133, as against 88 for the earlier year. This illustration could be extended to include all persons living on annuities, pensions, insurance benefits, or interest from bonds; all institutions (such as colleges) operating largely on endowments; and, to a somewhat lesser degree, salaried workers as contrasted with wage earners.

The Plight of the Salaried Worker.—The term “salaried worker” refers here to types of wage earners whose incomes are on an annual or monthly, and not upon a weekly basis. This classification includes, of course, teachers, preachers, government employees, office workers, and a host of others. The important fact about the incomes of these persons is that, while salaries may change somewhat to meet changes in price levels, they almost invariably change very slowly. There is, for example, the case of the college teacher who in 1913 was receiving a salary of \$2000. This was a very small income, to be sure, but with strict economy he was able to make ends meet. By 1920 his salary had increased to \$3000; but because of the tremendous increase in prices he could buy with the larger salary only as much as \$1530 would have bought him in 1913. This is a typical example of the difficulties in which salaried workers find themselves in a period of rapidly increasing prices.

The Case of the Wage Earner.—Skilled artisans and common laborers are usually referred to as “wage earners,” in order to distinguish them from salaried workers. The wage earner is often, though not always, paid on a weekly basis, and the income he receives is the result of frequent bargainings. In many instances, wage earners belong to trade unions, and wage agreements are drawn up by officials of the unions every year or two, or as often as every six months. As a consequence of these frequent bargainings over wages (which take place with unorganized workers also), the earnings of the wage earners are more likely to keep pace with rising prices than are the earnings of salaried employees. Nevertheless, it is a fact, as may be seen by an examination of statistics, that increases in wages usually lag behind rises in prices. A wage agreement continues in effect, let us say, for six months; but during the six-month period prices may increase materially, and thus cause the wage earner to lose out to some extent so far as purchasing power is concerned. The point is expressed in the well-known saying, “Prices take the elevator, while wages climb the stairs.”

It should be noted, however, that the money incomes of certain classes of wage earners may at times rise faster than the cost of living in periods of rising price levels. Government figures show that the cost of living

in the United States as a whole rose only 7 per cent between August, 1939, and June, 1941, but the average weekly earnings of workers in ninety *manufacturing industries* increased 30 per cent in this period. These larger money wages are accounted for by greater regularity of employment, an increase in the length of the working week, by some workers "moving up from lower to higher paying positions as the defense industries called for increasing numbers of skilled and semi-skilled workers," and by some increases in *wage rates* due to the greatly increased demand for labor in essential defense industries.⁵ We see, therefore, that—in many cases at least—these larger earnings do not represent increased incomes *for the same amount and the same grade of work*. Moreover, the gains in real wages that come to some wage earners at the beginning of a period of rising prices may vanish fairly promptly, and even those who are thus specially favored are likely to lose out in the long run through the failure of their money wages even to keep pace with the mounting cost of living.

The Effects of Falling Prices.—Our attention has been centered chiefly upon the results of *rising* prices, because increases in prices have particularly serious effects upon persons of relatively small incomes. When prices fall, the effects are the reverse, of course. Purchasing power, which has shrunk during the upward course of prices, expands again when prices are on the downward trend. It might be supposed that a balance would be reached in this way, but, so far as a given individual is concerned, there is no assurance that he will regain through falling prices anything like as much as he has lost through a rise in the price level. And it should be observed that, though salaried employees and wage earners ordinarily gain in times of falling prices *if they hold their jobs*, the fact is that unemployment is often painfully extensive at such times, as was shown during the period of declining prices and *increasing unemployment* following 1929.

Business men who have goods to sell are usually gainers through advances in the price level, since their costs of production ordinarily do not increase so fast as the selling price of the finished product increases. As a consequence, business men sometimes welcome rising prices, since they feel that the gains made on the upgrade will be greater than the losses which are incurred when prices again decline. This is a matter which we shall touch upon again in the next chapter.

PROPOSED SOLUTIONS OF THE PROBLEM OF PRICE LEVEL CHANGES

Because of the disadvantages of changes in price levels, such as those which we have outlined, attempts have been made to discover a remedy for what many consider a serious economic disorder. In general, the pro-

⁵ Cf. Meyer Jacobstein and Harold G. Moulton, *Effects of the Defense Program on Prices, Wages, and Profits*, Washington, Brookings Institution, 1941.

posals have been of two kinds. First, plans have been suggested for lessening the evil effects of price level changes without eliminating the changes in price levels themselves; and, second, there have been proposals for stabilizing prices through the control of the circulating media (M and M').

The "Market-basket Plan."—One of the most interesting suggestions for avoiding the harmful effects of price changes is known as the "market-basket plan." The Philadelphia Rapid Transit Company used this plan for more than a decade to guarantee its employees a stable standard of living; but it was abandoned when this corporation was reorganized as the Philadelphia Transportation Company. The plan was designed to keep wages and prices always on the same level. Since the price level could not be controlled by the Philadelphia Rapid Transit Company, this company did what appeared to be the next best thing; namely, it increased wages as the price level rose, and decreased wages as the price level fell.

The market-basket plan used an index number based on 184 articles which were in sufficiently "general use to influence accurately the changes in the purchasing power of the employee's dollar." Among these items were "rent, shirts, stockings, nut coal, kerosene, brooms, sewing machines, pork chops, gas, tobacco, quinine pills and haircuts." From time to time the articles used in making the index number were priced in the stores and markets patronized by P.R.T. employees. If, at the close of the year, prices were found to have varied as much as 5 per cent, the basic wage was changed to meet this variation. It was contemplated, therefore, that changes in wages would ordinarily be made only once a year; but a variation of 10 per cent or more for a period of three months was met by a corresponding change in money wages.

The purpose of the plan, as stated by the company, was "to assure to the employee and his family their present standard of living, in bad times as well as in good." This did not mean that P.R.T. employees had no opportunity to improve their standard of living. Wages could still be increased, as before, by convincing the management that higher wages should be paid. The P.R.T. market-basket plan simply assured the employee that his standard of living would not be affected by such a force as fluctuating prices, which were wholly beyond his control.

There would seem to be at least two possibilities of serious trouble in operating a plan of this kind: If prices, and consequently wages, took a pronounced drop (say, to the extent of 20 per cent), it would probably be difficult to convince the employees that they were not being imposed upon. For the average worker finds it hard to understand that \$32 a week with a low price level means as much purchasing power as \$40 a week when the price level is higher. And if prices rose greatly (say, to double their base level), though the employee would surely not object

to receiving \$80 a week in place of the usual \$40, it would probably be difficult for the company to secure sufficient revenue to enable it to advance wages to this extent.

Difficulties such as these were foreseen by the Philadelphia Rapid Transit Company when the plan was inaugurated, but the obstacle which finally emerged was of a somewhat different type. The decline in general prices which followed 1929 was accompanied by several P.R.T. wage cuts, based on their curve of falling prices. But in June, 1932, it was necessary (because of greatly reduced revenue resulting from the depression) to cut wages slightly below the point indicated by the price curve. In the face of this emergency, the market-basket plan was suspended temporarily. One year later, when both revenue and general prices had increased, the plan again went into active operation, with a rise in wages which brought the purchasing power of P.R.T. employees once more up to the level of predepression days, and continued to function until the company was reorganized.

Multiple Standard of Deferred Payments.—A second plan for avoiding evil effects of price changes, which we shall not be able to examine in detail, relates to long-term credits. It is called the Multiple or Tabular Standard of Deferred Payments, and is similar in general principle to the P.R.T. Plan. The idea is that debtors, in meeting their obligations, should pay to creditors not the number of dollars, but the quantity of purchasing power, that they have borrowed. If, under this plan, \$1000 were borrowed in 1913 and repaid in 1920, the payment would not consist of a mere \$1000 (which would represent in 1920 about \$510 of purchasing power on the 1913 basis) but \$1950 (which in 1920 would buy as much as \$1000, the amount borrowed, would have bought in 1913).

Without going further into plans of this kind, it may be said that there would be numerous difficulties in the actual working out of such plans as we have reviewed. We have noted several of these difficulties. Still another is that of finding a thoroughly acceptable index for measuring price changes. It would appear that arrangements such as these are scarcely feasible so long as they are adopted by only a few persons or organizations.

The "Stabilized Dollar."—Another attempt to solve the problem of changing prices is to stabilize prices through the control of the circulating media. One of the best-known plans of this type is usually referred to as the "stabilized dollar" or "compensated gold dollar," and has been associated with the name of Professor Irving Fisher.

We can give here only the barest outline of the plan. We have seen that a rise in prices means a fall in the value of gold, and vice versa. Professor Fisher wants a dollar which will always buy the same amount of goods, and he proposes to get it by increasing or decreasing the amount of gold in the dollar as prices show a tendency to rise or fall.

The plan includes:

1. A monthly index number.
2. The removal of all gold from circulation, and the use of circulating media consisting only of gold certificates.
3. A variation in the amount of gold that a "gold certificate" will command at the mint, this variation corresponding to general price changes.

We may see how the plan would presumably work, by assuming that all money in circulation is represented by one dollar, and that the index number is 100. Now let us suppose that the index number rises to 110. This means, of course, that sellers of goods are no longer willing to exchange their products for the amount of gold contained in a dollar, but demand the amount of gold contained in \$1.10. Since gold is thus actually less valuable than it has been, a gold certificate called a "dollar" should command more actual gold than it formerly did. Professor Fisher would make this literally true; the gold certificate presented at the mint when the index number is 110 would *in fact* command 10 per cent more gold than it commanded when the index number was 100.

And now, since the gold certificate does exchange at the mint for the amount of gold demanded by sellers for their goods, namely, 110 per cent of the former amount, it will readily exchange for the same amount of goods as before the rise in the index number took place; for sellers are now getting in each gold certificate the amount of gold that they are demanding. In this way prices would forever remain unchanged, as expressed in gold certificates; or, more correctly, prices would always tend to fluctuate about the index number of 100.

Control of Credit by the Federal Reserve System.—The most serious objection that has been raised to Professor Fisher's "stabilized dollar" is based upon the fact that most business today is transacted with credit and not with gold. While there is a relationship between the volume of credit and the quantity of gold, because of the existence of gold reserves on the strength of which credit is so largely issued, this relationship, according to some economists, is not sufficiently close to bring about the results which Professor Fisher predicts.

Consequently, it has been proposed by many students of the problem that prices be stabilized through the control of credit by the Board of Governors of the Federal Reserve System. Since at least 90 per cent of the business of the country is conducted on the basis of credit, this seems to be a logical spot for attack. Much of this credit, as was explained in earlier chapters, is extended through the rediscounting process provided by the Reserve System, which permits member banks to expand their credit by giving commercial paper as security.

We have seen also that the Federal Reserve System can encourage or discourage the rediscounting of commercial paper by lowering or raising

the rediscount rate and in this way can control, to some extent at least, the amount of credit (or M') in circulation. If the price level shows a disposition to rise above what the Board of Governors regards as normal, an increase in the rediscount rate will tend to contract credit and bring the level down; and an increase in the reserves required by the Board against demand deposits will have a similar effect. On the other hand, a decrease in the rediscount rate will have the effect of encouraging an extension of credit and thus bring about a rise in the price level. But this is not the whole story, for, as we have already seen, the Board of Governors may encourage or discourage the extension of credit by member banks, by lowering or raising the legal reserve rates for demand deposits and by engaging in open-market operations.

Control of credit through the Board of Governors seems to offer the most thoroughgoing, and in some respects the best, plan that has yet been advocated for the stabilization of the price level. But the task of controlling the price level through credit control would not be an easy one; on the contrary, it would involve the assumption of tremendous responsibility by the Board, and the necessity of meeting the objections of those whose individual interests would at times be threatened by measures adopted by the Board in protecting the interests of society in general. The level at which to stabilize would cause a terrific amount of controversy, as is evident from the criticism that was directed at President Roosevelt's proposal in 1933 to raise general prices before trying to stabilize them. We have already spoken of the problem of arriving at an index which would win general approval. As for evidence of conflict between individual and public interest, and of pressure that certain groups would attempt to exert upon the Board, we have only to refer to 1928 and 1929, when every effort of the Board to curtail credit was denounced by one group or another as a move which would discourage business.

Of course, the fact that a task is difficult of accomplishment is no adequate excuse for failing to undertake it, if the goal to be reached is really worth while. We are doing our best, in modern times, to lessen the uncertainties of life through such devices as insurance. The risks due to price fluctuations have been very great, and the consequences of general price changes have borne heavily upon many members of society. It would seem, then, that this element of hazard should, if possible, be eliminated—though this would mean the disappearance of a large part of business profits, which (as we saw in Chapter 22 of Volume 1) arise out of the uncertainties of economic life. That price fluctuations should be controlled was obviously the view of a group of bankers who, some years ago, passed the following resolution: "It is the self-evident duty of the [Board of Governors] to administer the Federal Reserve account in such a manner as will safeguard the nation from inflation and deflation in the future, and we heartily approve of sincere efforts being

made to find and apply the best legislative method for safeguarding the purchasing power of money."⁶

War-time Control of Prices.—The abnormal conditions that prevail when a nation is carrying on or preparing for war are almost certain to lead to a sensational rise in the price level. The precipitate rise in general prices from 1914 to 1920, and the post-1940 increase that accompanied the all-out defense effort against totalitarian aggression, are cases in point.

The mobilization of a great modern nation for war requires huge governmental purchases of goods to be used by its military, naval, and air forces. It is likely to meet these unusual expenditures, in large part, by borrowing through the expansion of bank credit; and it may even find it necessary to issue paper money in large amounts. The consequence is an expansion of money or credit, or both, at a more rapid rate than the expansion of production. Business men borrow from banks so that they may expand greatly their purchases of raw materials, in anticipation of shortages or price increases. The fear of shortages and price increases may also cause consumers to spend their money incomes more promptly than usual and thus speed up the velocity of circulation. Moreover, the amount of these money incomes is larger than usual, for business men raise wages by competitive bidding for labor; and these wage increases add still further to the total quantity of circulating media. The whole situation—as we have already noted, and shall emphasize again in the following chapter—is one in which there are many forces tending to push prices ever higher.

War-time conditions seem to call for strict measures of control if the price level is not to get out of hand. The ideal solution would be to finance the war by means of taxation. If, for example, the government needed \$25,000,000,000 out of a \$100,000,000,000 national income for war purposes, it would be desirable, in many respects, to reduce *ordinary* production by that amount, levying taxes which would convert 25 per cent of the nation's production into the sinews of war. Since high taxes are always unpopular, it might be more expedient to adopt lower taxes and finance the war in part by means of enforced savings.⁷ In this event, the government would take over a portion of individual incomes, promising to return the amounts withheld after the emergency had passed. Yet another non-inflationary method of raising war funds is by selling bonds, provided of course they are paid for out of current (and not borrowed) income and are both non-exchangeable for economic goods and ineligible as a basis for making loans while the emergency lasts.

These methods of war financing have the special merit of transferring purchasing power from individuals to the government, reducing *ordinary*

⁶ Iowa Bankers' Association, in convention at Ames, Iowa, 1923.

⁷ As proposed by John Maynard Keynes and others.

consumption by an amount equal to the increase in *war consumption*, and discouraging an expansion in the total volume of circulating media. If they were supplemented by the measures which the Board of Governors of the Federal Reserve System may employ in controlling the expansion of credit, and if the government abstained from the issuance of fiat money, it seems likely that the price level could be kept within reasonable bounds. Of course, the prices of some individual commodities would rise in response to unusual conditions of supply and demand, the prices of war materials bought by the government might have to be set by governmental agencies to prevent them from skyrocketing, and rationing might be necessary to insure a fair distribution of certain scarce, essential goods among the populace. But the price level itself could probably be controlled sufficiently well to enable the country to avoid such grave injustices as have been inflicted in the past by the failure to control war-time prices.⁸

Conclusion.—We must not close this discussion without noting the fact that some extremely able financial experts doubt the desirability of attempting to control the general price level (because of economic disturbances which might result from such an attempt) and, further, seriously question the ability of the Board of Governors, or similar agency, to bring about a stabilization of general prices. On these two points, then, the final word has not been written. We cannot undertake, within the limits of a single chapter, to examine further the first of these two points. As to the second, it seems unlikely that we shall know definitely whether stabilization can be effected by the Board of Governors until we have given this body specific authorization to make the attempt, over a period sufficiently long to provide a fair trial.

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1. Distinguish between individual prices and general prices.
 2. What is the purpose of price index numbers?
 3. How and why are price index numbers weighted?
 4. Distinguish between a *general* index and a *wholesale commodity* index.
 5. What type of index is the one compiled by the United States Bureau of Labor Statistics and referred to in the text?
 6. What is the relationship between a general price index, and an index of purchasing power, such as those presented in Table 40?
 7. How did the purchasing power of the dollar in 1915, 1920, 1925, and 1939 compare with its purchasing power in 1926?
 8. Write the equation of exchange, and explain the significance of each factor in the equation.
 9. Demonstrate arithmetically that a doubling of the quantity of circulating media (other things remaining unchanged) will cause a doubling of the price level.

⁸ This problem is treated clearly and concisely in C. O. Hardy, *Wartime Control of Prices*, Washington, Brookings Institution, 1940, which has been especially helpful in the preparation of this brief statement.

10. How does the introduction of credit affect the equation of exchange?
11. What is the Quantity Theory of Money?
12. What historical evidence have we that changes in M and M' may be responsible, in large measure, for changes in price levels?
13. "High prices and low prices are equally harmless, if only one or the other, once adopted, will 'stay put.'" Explain.
14. "Gains and losses are likely to occur whenever there is an extension of credit over a period of years." Why?
15. If a person borrows when prices are low and repays when prices are high, does he gain or lose by the change in price levels?
16. What are the effects of general price changes upon persons who are dependent upon fixed money incomes?
17. "Prices take the elevator while wages climb the stairs." Explain, in connection with price levels.
18. Is the "wage earner" or the "salaried worker" the more favorably situated when general prices are rising? When they are falling?
19. Are "business men" more likely to welcome rises or declines in general prices? Why?
20. What was the specific purpose of the "market-basket plan"?
21. Give a brief description of this plan.
22. What difficulties might arise in the operation of the market-basket plan in the event of extreme changes in prices, either upward or downward?
23. What is the central idea of the Multiple Standard of Deferred Payments?
24. Outline Professor Fisher's plan for stabilizing the dollar, and explain how, presumably, it would operate.
25. What, if anything, could the Board of Governors of the Federal Reserve System do to stabilize general prices?
26. Compare price changes from 1910 to 1919 with changes from 1929 to 1933.
27. What is the attitude of the Iowa Bankers' Association in the matter of the control of prices?

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CHAPTER 37

BUSINESS CYCLES

IN OUR examination of the purchasing power of money in the preceding chapter, we noted that general prices sometimes undergo extensive changes over a period of years. We shall see in the present chapter that there are fluctuations in business activity as well as in price levels. Indeed, the two are not unrelated; but our present concern is not so much with fluctuations in prices as with changes in economic activity. Changes of the type which we shall discuss are usually called business cycles.

THE NATURE OF THE BUSINESS CYCLE

"Business cycles are a species of fluctuations in the economic activities of organized communities. The adjective 'business' restricts the concept to fluctuations in activities which are systematically conducted on a commercial basis. The noun 'cycles' bars out fluctuations which do not recur with a measure of regularity."¹ This statement by a well-known authority is a satisfactory definition of business cycles, but it does not profess, of course, to be a description of these economic fluctuations. The nature of business cycles may be explained most clearly through the use of a chart indicating changes in industrial production.

A Chart of Business Activity.—In Fig. 52 we have a graphic presentation of the business cycle as it is reflected in changes in the volume of industrial production.² Production may be counted upon ordinarily to increase in volume from year to year because of the demands of increased population. This growth is shown in Fig. 52 by a gradually rising central line curve which shows that, on the whole, business activity has been increasing during the past half-century. Had productive activities of the kinds here represented not experienced sharp fluctuations between 1890 and 1940, this trend curve would represent with a fair degree of accuracy the steady, continually growing volume of business transactions.

But a smooth, slowly ascending curve does not picture truly the productive activity of 1890 to 1940, or of any other reasonably long period,

¹ Wesley C. Mitchell, *Business Cycles*, New York, National Bureau of Economic Research, Inc., 1927, p. 468.

² Based on data of Standard Statistics Company, Inc.

for that matter. For experience shows that business activity fluctuates from the general trend, now greatly and again but slightly. The extensive fluctuations, as we have said, are called business cycles. Referring to our chart, we note that, during this fifty-one-year period, industrial activity shifted a number of times from one side of the trend curve to the other.

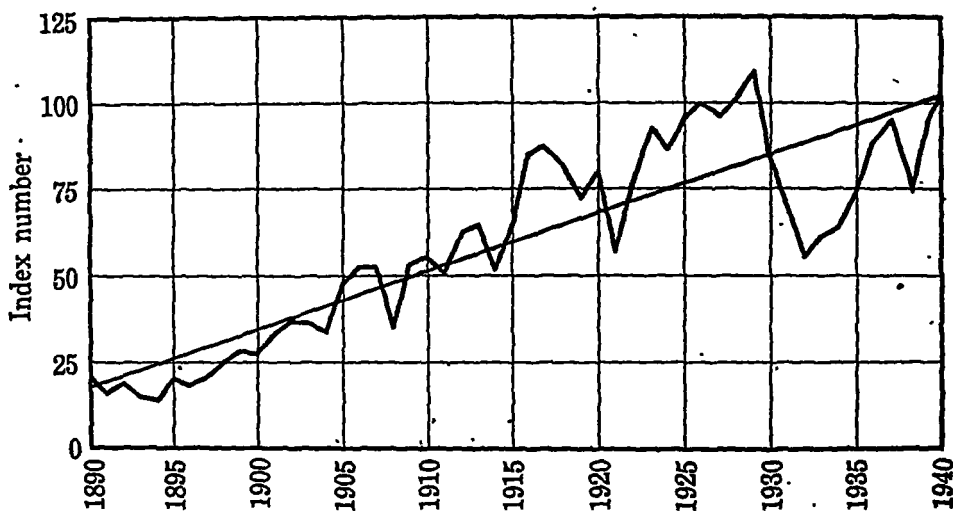


FIG. 52.—THE BUSINESS CYCLE

This chart shows fluctuations in business from 1890 to 1940, as indicated by a curve of economic activity for these years. (1926 = 100.)

It is shifts of this kind with which we are concerned in dealing with business cycles. Unless history fails to repeat itself, the curve of actual production (which in 1932 was far below the trend curve) will eventually go well above the trend curve of production.

Length of the Business Cycle.—Fluctuations in productive activity are sometimes great and sometimes small. There may be, in a single year, a number of minor fluctuations that cannot readily be shown on a small chart. Changes of this kind are of relatively slight significance. The business cycle proper covers a longer period than a year, and such fluctuations in business activity are much greater than those of any single year. The word "cycle," which has been so widely adopted in designating this particular economic phenomenon, suggests not only (as is stated in our definition) that the fluctuations recur with a measure of regularity but, further, that there is a return to a position of business activity previously occupied.

Our chart shows, for example, that production was at a low ebb in 1914. Then came a rise in activity which in two years took production farther above the trend curve than it had previously been below. Following this spurt of productivity, there were several years of minor fluctuations, with a serious slump in 1921 from which business did not recover

fully for almost two years. In this recovery, however, a new height of business activity was reached by the middle of 1923. Business was good from 1923 to 1929, with the exception of rather minor depressions in 1924 and 1927, which are indicated by the decline of the production curve in those years. The peak reached in 1929 represented a new "high" for productive activity in the United States. Close upon this banner year came the post-1929 depression. The volume of production in 1932 was only about one-half as great as in 1929, but it has been increasing ever since, except for the year 1938, and in 1940 crossed over from the mournful to the cheerful side of the trend curve.

Thus we can see, without following further in detail the curve showing actual production during this fifty-one-year period, that the business cycle moves in wave-like motions. Not only does production tend to "come back" after it has suffered a recession, but the tendency is normally to strike a new high level of productive activity. This new level, we may once more note, is attributable largely to growth in population, but in part also to increases in individual demand which presumably represent improvements in standards of living.

"Periods" of the Business Cycle.—It is customary, in describing the business cycle, to refer to several well-defined periods or phases which appear to accompany these wave-like changes in business activity. They may be listed as follows:

1. The period of prosperity.
2. The period of liquidation.
3. The period of depression.
4. The period of recovery.

We shall examine these periods briefly, describing the effects of each upon industrial activity, prices, employment, and other elements that go to make up economic life. Table 41 is virtually an outline of this description, since it gives in tabular form the characteristics by which the periods of the business cycle are marked.

TABLE 41.—CHARACTERISTICS OF THE BUSINESS CYCLE

	Period of Prosperity	Period of Liquidation	Period of Depression	Period of Recovery
1. Industrial activity.....	Maximum	Decreasing	Minimum	Increasing
2. Prices.....	High	Falling	Low	Rising
3. Employment.....	Maximum	Decreasing	Minimum	Increasing
4. Wages.....	High	Falling	Low	Rising
5. Strikes.....	Many	Many	Few	Increasing
6. Business failures.....	Few	Increasing	Many	Decreasing
7. Bank deposits.....	Large	Decreasing	Small	Increasing
8. Bank reserves.....	Low	Increasing	High	Decreasing
9. Interest rates.....	High	Falling	Low	Rising

The Period of Prosperity.—The period of prosperity is one of great industrial activity. Prices are high and stocks of goods, called forth by the inducement of high profits, are large. In the period of prosperity there is plenty of employment for workers, and wages are naturally high. Nevertheless, strikes are not unusual in this phase of the business cycle, since the workers, knowing that labor is relatively scarce and that business men are doing well, are likely to insist upon wage increases. Business failures, of course, are at a minimum, for this is a time when business men of even ordinary ability can make good profits.³

The items thus far mentioned relate to the manufacturing and commercial side of business, as contrasted with the financial side. So far as finances are concerned, there is a great expansion of bank credit during the period of prosperity. On this account, bank statements are frequently unsatisfactory; that is, they show small reserves, owing to the fact that banks have expanded credit greatly in response to the demands of business men. Because there has been a large expansion of credit and bank reserves are low, interest rates are usually high in the period of prosperity.

The Period of Liquidation.—The period of liquidation is very unlike the period of prosperity upon which it follows, sometimes with appalling suddenness. In this phase of the business cycle, industrial activity is definitely curtailed and on the downward trend. Stocks of goods that have piled up during the preceding period are larger than can be disposed of readily, and as a consequence prices decline. For the same reason, and sometimes for other reasons which will be explained later, there is likely to be a good deal of unemployment. Unemployment means falling wages, since it permits the employer to replace present workers with others at lower figures, if employees will not take wage reductions. Nevertheless, workers, in the effort to maintain their wage scales, are not unlikely to go on strike to resist wage decreases, so that strikes are numerous in this period. Business failures are, of course, much more common in times of liquidation than in times of prosperity, and over a considerable stretch of time they become increasingly numerous. This, of course, is as we should expect it to be, for the period of liquidation is "settling up" time, when concerns that cannot meet their obligations are forced into bankruptcy.

Turning to the financial side of business, we find that bank credit is in process of contraction in periods of liquidation, since there is a tendency on the part of banks to call in their loans. This means increasingly larger reserves in the possession of the banks, so that bank statements are more satisfactory than in the period of prosperity. Because of the demands of business concerns for credit and the hesitancy shown by banks in extend-

³ But even in periods of prosperity, the number of business failures is startlingly high, as may be seen by reference to figures given in chap. 10 (vol. 1).

ing credit at this time, interest rates are likely to be high, though in the process of falling.

The Period of Depression.—Following industrial crisis comes the period of depression, during which industrial activity is at its lowest ebb. Because there is a small demand for commodities, prices of goods also are at their lowest. Since the demand is so slight, merchants and manufacturers are able to fill orders from stocks of goods which have been held over from the previous periods, and these stocks are depleted but slowly. The absence of extensive orders and the existence of sufficient stocks on hand make it unnecessary to keep industrial plants running, and as a consequence there is much unemployment.

Employers find it possible, during a period of depression, to force workers to take reductions in wages. Though there is a temptation to resort to strikes in order to resist wage reductions, the workers who have employment, realizing the weakness of their bargaining position and anxious to retain their jobs, usually accept whatever terms are offered by the employers; hence there are few strikes in time of depression. This is a most difficult period in which to conduct business. Some of the less capable enterprisers are unable to survive this trying period, and business failures are numerous.

Since business is simply marking time, there is little call for bank credit, and borrowings by business men are at a minimum. Former loans have been repaid, and bank statements are favorable, showing large reserves in relation to the amount of credit outstanding. The existence of these large reserves makes bankers eager to place loans, and this eagerness is manifested in low interest rates. But despite their willingness to use their resources profitably, the bankers often exercise in the period of depression an excess of caution in respect to eligibility of loans, which prevents borrowing by those who could use bank credit legitimately and advantageously. This undue caution is a hang-over from the period of liquidation, when banks have found it difficult and oftentimes impossible to collect the amounts due them.

The Period of Recovery.—Business depression fortunately cannot last forever, but gives way to a phase of the business cycle known as the period of recovery. The wheels of industry begin to turn once more, in order to make goods necessitated by the depletion of stocks which have gradually been purchased even in time of depression. Increased demand brings with it a rise in prices, and the prospect of good prices leads to industrial activity which soon results in a fair-sized stock of goods. Unemployment begins to disappear, since mines, mills, and factories cannot be run without workers. Wages, which had been low in the preceding period, show an improvement; and wage earners, glad to find steady employment once more, manifest but little disposition to call strikes at the outset of the period of recovery. However, strikes increase in number

as business continues to improve and workers seek to regain the wage losses suffered during the depression. Business failures are much less numerous than during a period of depression; the number of bankruptcies declines steadily in this and the following period.

Now that business is improving, business men resume once more the practice of borrowing, and there is an increase in bank credit. This means, of course, that the expansion of credit by banks appears in bank statements, and the reserve percentages decline steadily as loans increase in volume. Since bankers now have plenty of opportunities to lend out funds, there is no need to offer the inducement of low rates of interest; consequently, the interest rates rise during the period of recovery because of the expansion of bank credit.

The cyclical nature of business fluctuations is indicated by the fact that the period of recovery is followed by a period of prosperity. Thus we are brought back to our original starting point; but the height of industrial activity in this return is likely to be greater than in the preceding period of prosperity. Referring again to Fig. 52, we may note once more the great irregularity in business activity indicated by the now-rising, now-falling curve of production. It is evident, however, that the level of industrial production reached in our latest period of prosperity, that of 1929, was distinctly higher than the level attained in any previous period.

PROBABLE CAUSES OF THE BUSINESS CYCLE

The Problem of Explaining the Cycle.—The frequency of occurrence and the general similarity of business cycles constitute the basis for believing that it may be possible to find a general explanation of the manner in which each peak of prosperity leads ultimately to crisis, and a new peak eventually begins to rise from the trough of depression. But it would be quite a different matter to secure general acceptance of any specific explanation. Business cycles cannot be studied in the laboratory, but must be observed in their particular historical context. Almost invariably there are certain random factors that are peculiar to any given historical period. Hence, it is easier to find an explanation for an individual business cycle in specific terms than in general terms.

The problem is further complicated by the common tendency to seek monistic interpretations and explanations of developments in any field of inquiry. As we have seen, the business cycle is related to prices, production, finance—in short, to most aspects of business activity. It would seem to follow that developments in any of these fields might in part explain the development of the cycle. Moreover, the psychological factor, as distinct from the economic, may play an important part in bringing about cyclical movements, and the political factor is assuming increasing importance. For these reasons, any monistic explanation must

be suspect. Pluralistic explanations, on the other hand, run the risk of being so general in nature as to be either meaningless in terms of definite cause-and-effect relationships, or incapable of being verified with accuracy, or both.

Factors Influencing the Cycle.—Business cycle theories by the score have been developed, each stressing a particular "cause" as being solely or chiefly responsible for cyclical fluctuations in business activity. We are told that business cycles are caused by sunspots, rainfall, wars, discoveries and inventions, and changes in population; by overproduction; by underconsumption; by the instability of our money and credit system; and by undue optimism or pessimism on the part of business enterprisers. It is not possible for us to examine these many theories critically.⁴ And since any monistic theory would seem to constitute an oversimplification, it is probably best to restrict ourselves to a description of the operation of certain factors which appear to play a part in any satisfactory explanation. These include industrial, financial, and psychological conditions.

By *industrial* conditions, we mean levels of production, commodity prices, wages, profits, the volume of employment, and the degree of industrial unrest. Cyclical fluctuations are generally measured in terms of these conditions. The most important of the lot is probably the level of production, since the other conditions may be expected to vary primarily as a result of earlier changes in the volume of production. By *financial* conditions, we mean primarily the level of bank reserves and bank deposits, and the nature of the prevailing rate of interest. By *psychological* conditions, we mean the degree of optimism or pessimism which exists among those who play an active rôle in the guidance and direction of production. It is unquestionably true that business cycles are not purely mechanistic in character. If undue optimism or pessimism characterizes the attitude of the enterpriser and the capitalist, business activity may expand in the face of structural weaknesses in the economic system, or decline to a low level when external conditions are apparently favorable for expansion.

The "Self-generating" Theory: A Pluralistic Explanation of the Business Cycle.—The crux of the problem is to ascertain what factor or factors are responsible for the transition from one period to another. This does not mean a mere enumeration of the consequences of such a change, once it has begun. Nor is it the same thing as listing the wide variety of developments which might affect the duration and extent of a movement in a given direction, once that movement has started. To speak of the beginning of a cycle, however, is a contradiction in terms, for a cycle (like a circle) obviously has neither beginning nor end, but is a continuous process. Therefore, we must break into the cycle at an arbitrary point,

⁴ They are dealt with in detail in Gottfried von Haberler, *Prosperity and Depression*, Geneva, League of Nations, 1937.

and seek to determine why the conditions then existing failed to continue indefinitely, and instead were transformed in such a way as to bring about a passage from one period of the cycle to the next. To attempt to work backwards is impossible, for in so doing we should inevitably be forced to make our way through an infinite number of earlier stages. We must start, therefore, at some arbitrarily selected point and work forward.

Prosperity and the Trend Toward Crisis.—Admitting, then, that our selection of a particular point is arbitrary, let us break into a “normal” business cycle during the period of prosperity. This period, as we have noted, is one in which business is booming. It is, among other things, a time of progressively higher prices. Rising prices mean large profits for business men. Goods are produced in anticipation of demand, and if prices are increasing steadily, commodities may be disposed of at figures which are often considerably in excess of the costs of production. For the selling price of goods in a period of rising prices will tend to be the cost of production of such goods at the time at which the sale is made. This price may be considerably greater than the actual cost in a period of rising prices, since into the making of the commodity in question have gone raw materials and labor purchased some time before the sale of the finished good, and purchased therefore at relatively low prices. Moreover, interest charges, salaries, and certain other items of expense almost never keep pace with rising prices. The net effect of these conditions is that profits are large when prices are on the upgrade.

Since business men are anxious to reap these high profits, they make every effort to expand production in times of rising prices, and on this account stocks of goods, employment, and wages are usually at their height in a period of prosperity. The truth is that toward the end of this period the industrial bubble is about ready to burst. Expansion in the production of goods is matched by an expansion in financial activity. The one, of course, has given rise to the other, for bank credits are expanded to their limits only when business is or has been booming.

The psychological attitude during the greater part of the period of prosperity is one of optimism. Business men, since they are making large profits, are naturally optimistic. But there comes finally a time when this optimistic attitude may be assumed rather than real. Captains of industry sometimes whistle to keep up their courage. Though they wish for and talk much about continued prosperity, they begin sooner or later to be fearful that the peak of industrial activity has about been reached. They know from experience that business activity runs in cycles and that periods of prosperity are followed by industrial crisis and depression. With the boom fully expanded, and with doubt and uncertainty in the air, it sometimes requires only a slight jar to change the period of prosperity into one of industrial crisis and liquidation. Sometimes, as in 1929, this jar appears in the form of a crash in the stock market.

Crisis, Liquidation, and the Beginnings of Depression.—It is possible that in one or more lines of manufacturing there has been too great production during the period of prosperity, owing to the desire of business enterprisers to make large profits while prices are high. There may be, for example, an overproduction of automobiles, or radio sets, or some other article manufactured on a very large scale. When sales fail to keep pace with production, the natural tendency is to curtail production. An oversupply of automobiles may easily result in the closing of the plants of one or more of our leading automobile manufacturers. An action of this kind throws out of work many thousands of wage earners. Not only is the purchasing power of these workers reduced, with a consequent depressing effect upon other industries, but a move of this kind is interpreted by many other business men as a sign that the period of prosperity has come to an end.

Other manufacturers decide upon a curtailment of their productive operations. Merchants having large quantities of goods on hand offer them at lowered prices in order to reduce their stocks and obtain funds. Manufacturers, now unable to sell at former high prices, demand that workers submit to reductions in wages. In the effort to resist wage cuts, employees resort to strikes, and again purchasing power is curtailed. Bank credit, which had been stretched to the utmost, is now contracted, for bankers, in view of the unsatisfactory industrial conditions, are anxious to call in their loans. But business men find it difficult to meet their financial obligations as these loans are called. In their effort to secure the necessary funds, manufacturers and merchants sacrifice stocks of goods on hand, and offer to pay high rates of interest for loans which will tide them over the emergency. Despite their best efforts, many are unable to weather the storm, and go down in bankruptcy.

The mental attitude of business men during the period of liquidation and in the early stages of depression is naturally one of doubt and fear. Not knowing what the immediate future will bring forth, but looking forward to some months of poor business, they hesitate to put into execution whatever projects they may have had in mind during the period of prosperity; and this lack of action leads definitely to that state of inaction, sometimes long drawn out, which is known as the period of depression.

Depression and the Move Toward Recovery.—This period, as we noted in an earlier description, is one which finds business virtually flat on its back. Tendencies which were apparent in the period of liquidation have been allowed to run their course, with the result that production has come almost to a standstill. The psychological atmosphere of the period of depression is one of extreme pessimism. With business in a state of suspended animation, no one seems to know just what steps should be taken to bring it back to life. And yet, if the self-generating theory is

sound, it is in this very condition of business prostration that the causes which lead to the next phase of the business cycle, the period of recovery, must be sought:

Recovery and the Causes of Prosperity.—It is probable that the starting point of revival is usually the exhaustion of stocks of goods. It may be that the surplus of automobiles, which we suggested as bringing to an end the period of prosperity, has slowly been disposed of, and that there is again a demand for cars which will be available only if automobile plants resume production. An announcement from Mr. Ford or the General Motors Corporation that operations are to be resumed and employment given to a hundred thousand men, would stimulate activity in businesses of all kinds.

Such an announcement would appear to many to herald the turning point of the tide. It is the final word for which the less venturesome have been waiting. Enterprisers throughout the country again take heart, and factories here and there resume operations or, in some cases, go on "full time" after a period of curtailed production. Workers are available at low wages at the outset of this period, materials may be had at bargain prices, and banks, because of their large reserves, are anxious to extend credit at moderate rates of interest. These particular advantages are likely to disappear as the revival of business makes considerable headway. That is to say, wages increase, interest rates rise, and other expenses advance as production assumes normal proportions. However, the attitude of business men is now one of increasing courage and optimism as regards the future. It is felt that the "slough of despond" has been passed, and that the months ahead hold bright prospects.

The process of recovery may be a relatively slow one, but in the course of a year or so machines are once more humming and the business cycle passes by almost imperceptible steps into the period of prosperity. Thus we find that in each of these several phases of the business cycle are the conditions which almost inevitably bring about the succeeding phase.

THE STABILIZATION OF BUSINESS

It is not suggested that the self-generating theory of business cycles provides a complete explanation of this particular economic phenomenon. Professor Mitchell himself, who has done more than any other writer to popularize the notion that business cycles are self-generating, admits that many other theories of business cycles have in them much of truth.

The Need for Stabilization.—But whatever the exact causes may be, it seems fairly clear that society would be better off if fluctuations in business activity could be avoided, or at least be made less violent. For these fluctuations bring uncertainty and fear; gains to some and losses to others; overexpansion of production in times of boom and bankruptcies in periods of liquidation and depression; unemployment and consequent loss

of income to workers; and other results that disturb and interfere with economic well-being.

Why, then, are these sharp fluctuations in business permitted to take place? Why, having lived through the various phases of the business cycle, including those distressing periods of liquidation and depression which necessitate the extension of public relief on a large scale, do not the persons affected determine to correct the situation, so far as the future is concerned, by removing the conditions that are responsible for wide variations in business activity?

Delays in Seeking a Solution.—There are several possible answers to questions of this nature. It appears, in the first place, that interest in the control of business fluctuations, as in the abolition of war, depends largely upon the urgency of the situation. When the hardships of business depression or of war are being experienced, the need for preventing the recurrence of such catastrophes is generally recognized, but those affected are so busily occupied with meeting the immediate emergency that they give little thought at the time to devising preventive policies for the future. When the emergency has passed and the period of recovery or reconstruction has set in, the demands of the present again loom up as all-important; and, since corrective measures have not been adopted, the forces that formerly brought disaster are again allowed to run their course, and before very long another crisis is imminent.

Wage Earners and Business Stability.—For more than a century we have had these ups and downs of business activity in the United States; and in this hundred-year period the country has experienced at least a dozen major cyclical movements in business activity, as well as many minor fluctuations. Among those who are hardest hit by reason of recurrent periods of unemployment are the wage earners of the country. And yet the wage-earning groups have done little or nothing to bring about stability of business and regularity of employment.

Indeed, organized labor has shown no real appreciation of the desirability of *preventing* business fluctuations. Labor leaders have spoken largely in terms of alleviating the unpleasant consequences of the depressions that are thrust upon them. They have favored the lessening of unemployment by reductions in hours of labor but not in pay, and by the extension of public works projects; and, in especially dark days, they have endorsed liberal public relief allowances for the involuntarily idle. But these are palliative and not preventive measures.

Wage earners have been severely criticized for their "stubbornness" in resisting wage cuts in time of crisis, liquidation, and depression. Their answer is that to take cuts would be to give up wage increases which were won through years of bargaining, and which once lost would not be easily regained. Though they accept willingly the larger incomes that come to them in periods of prosperity, they disclaim, and with some reason, re-

sponsibility for the depressions which follow. Wage earners, they say, are in the position of having to take orders; it is the business men of the country, the enterprisers, who are in positions of authority which enable them to determine the pace at which business shall proceed.

Business Leaders and Business Statistics.—Whether our business men can be convinced of the desirability of controlling production so that it may not expand unduly and in the course of time bring the inevitable reaction, remains to be seen. We have noted the fact that the period of prosperity is one of large profits, and it is questionable whether the average business man would willingly curb his desire for immediate profits merely because of the likelihood that excessive business expansion will be followed by a period of economic stagnation. Even if he were disposed to prevent production from exceeding the limits of safety, it would often be difficult for him to know when the limits had been reached.

It is true that there are the business records of previous years from which may be learned something of the likely trends in the future. But no two business cycles are exactly alike. It was thought for some time that these wave-like movements of business activity lasted about ten years from beginning to end; and at least two interesting theories were built upon the notion of periodicity. It has been found, however, that business cycles vary in length; and prior to 1929 some economists held that the cycles were becoming shorter all the time. Moreover, the phases or periods of one cycle are oftentimes quite different from those of another cycle. A depression, for example, may last only a few months, or it may extend over a year or two, or even over a half-decade or more as in the case of the post-1929 depression. As a result of these irregularities, enterprisers who might wish to avoid an unwarranted expansion in production are often puzzled to know at just what time expansion should be restrained.

The interest of business men in gaining knowledge of this kind is manifested in the growth of agencies that make statistical studies of business activity, and on the basis of their data undertake to forecast business conditions in the future. Work of this kind is improving in quality and increasing in popularity, and it seems probable that business men may eventually have placed before them information which will be of genuine assistance in reducing the violence of changes in economic activity.

Stabilization and the Federal Reserve System.—There are many persons who think that the Federal Reserve System should extend its powers and attempt to prevent overexpansion of business by discouraging borrowing whenever economic activities seem to have reached the limits of safety. One of the characteristics of the period of prosperity is a great increase in the volume of bank credit, without which there would be less of a business boom. This expansion of credit is possible because the commercial banks that are members of the Federal Reserve System are them-

selves able to get an extension of credit through the rediscounting of commercial paper.

If the Board of Governors of the System, following its traditional policy of seeking the public welfare, should raise the rediscount rate gradually (and if necessary, drastically) whenever a further increase in business appeared to be undesirable, it would seem that this advance in the interest charge might discourage further extension of credit and thus check unwise business expansion. And if, at the same time, the Federal Reserve banks should engage in selling securities in large quantities, this type of open-market operation, as we pointed out in an earlier chapter, would have a tendency to make the member banks less liberal in their lending to customers. And if, finally, the Board of Governors should raise the reserve requirements against demand deposits, it is very likely, indeed, that credit expansion would be discouraged.

An attempt of this kind on the part of the Board of Governors would doubtless call forth protests from a great many business men. There would be objections from those who would question the ability of any board to decide rightly the proper time at which to discourage borrowing, and from others anxious to reap large profits even at the expense of business expansion which might eventually lead to depression. Indeed, the Board followed an "easy money" policy—with low discount rates and large open-market purchases—for several years prior to the debacle of 1929, largely because of the fact that business men protested against any suggestion that the flow of credit should be checked. Some critics charged that the Federal Reserve System permitted excessive credit to get under way, and was then unable to check it.⁵ But the blame for this undue extension of credit should not be placed upon the Board alone. Surely a part of the responsibility lies with the business men, bankers, and so-called economists who talked about the economic "new era" that had been reached, and insisted that business must not be discouraged. Furthermore, it should be remembered that the Board has never as yet had a clear-cut mandate to attempt to regulate the volume of business through the agencies of regulation at its command.

It seems probable that much could be done to control business expansion and contraction through the measures we have described, provided the task was undertaken before we had moved too far from the "trend" curve of production. On this point we cannot speak with absolute assurance, since no adequate trial has yet been made of this method of regulation. If it should be found that the volume of business transacted in the country can be controlled effectively by these means, there would be need for absolute confidence in the integrity and disinterestedness of the members of the Board of Governors. For interference with business

⁵ Cf. W. H. Steiner and E. Shapiro, *Money and Banking*, New York, Henry Holt and Company, Inc., 2nd ed., 1941, p. 742.

processes, which might affect seriously the fortunes of certain individuals, could scarcely be justified except on the ground of a genuine benefit accruing to society through the regulatory action of the Board.

Price Control and Stabilization.—Professor Fisher has emphasized the close relationship that exists between steadily rising prices and the undue expansion of business. He has even gone so far as to suggest that if we could stabilize prices, we should do away with the strongest temptation to expand business beyond the safety point. For undue expansion, he says, results from the knowledge that abnormally large profits may be made in times of rising prices. If this theory is sound, then the control of the amount of credit by manipulation of the rediscount rate might have a stabilizing effect upon, first, the price level, and, second, the desire to expand business.

It would appear that an increase in the rediscount rate at the "proper moment" might be expected to affect the situation in two ways. First of all, it would tend to stabilize prices and thus put an end to exceptional profits; and it would, moreover, discourage an increase in credit available for the use of business men, and thus tend to hamper the further extension of business activities.

Stabilization Through Public Works.—Another suggestion which has been offered for lessening the violence of fluctuations in business is the development of public works at times when private industry is depressed. The construction of roads, bridges, public schools, courthouses, post offices, and many other kinds of public buildings might oftentimes be undertaken to relieve periods of business inactivity. Some forms of public work, no doubt, must be attended to without delay. It would seem foolish, for example, to wait for a business depression if the construction in question were that of a school building, and if delay meant inadequate facilities for a number of years.

But there are many kinds of public construction which could just as well be carried on when industry in general is inactive and workers by the thousands are seeking employment. This, indeed, appears to be the sensible time at which to build public works, if only from the point of view of expense; for bridges may be built and roads constructed at a much lower cost in periods of depression than at times of industrial boom. In the past, our practice in this respect has been to ignore almost wholly the possibilities of building public works at low prices and at the same time providing workers with a much needed opportunity to secure income through the performance of useful service.

If municipal, state, and federal officials were authorized to give due regard to industrial conditions in the placement of large orders, and if they exercised this authority wisely, something could be done to alleviate the suffering which so often accompanies major industrial depressions. But we must not overestimate the aid to be had from this source. Pro-

fessor William N. Loucks, who has studied public works in their relation to business depressions, estimates that if federal, state, and local public construction were planned so as to be executed in times of depression, probably on the average about 10 per cent of our present total volume of unemployment might thus be absorbed.⁶ Public works, properly timed, could therefore be employed for lessening somewhat the severity of depressions and for relieving unemployment during these periods, but they clearly do not constitute either a preventive or a cure for depressions.

Nevertheless, the United States government made huge appropriations for the construction of public works during the post-1929 business depression, partly, it would seem, for the purpose of providing work for some of the unemployed, and partly with the thought of stimulating business in general through a substantial increase in the total volume of business transactions. It was estimated by a Senate Commission that federal expenditures for relief purposes, in the five-year period from 1933 to 1937, aggregated more than \$14,000,000,000, much of which was for public works projects to be carried on in various parts of the country. Unfortunately, it is impossible to measure the extent to which unemployment was allayed and business stimulated by this great expenditure of public funds. Nor does this emergency spending throw much light upon the possible benefits to be realized through the operation of a thoroughgoing, well-coordinated, continuous program of public works that aims to promote the stabilization of economic activities.

Proposals for Reducing Unemployment and Relieving the Unemployed.—Numerous other suggestions for the stabilization of business have been offered. The provisions of the Social Security Act, relating to unemployment benefits for those who are involuntarily out of work, were noted in Chapter 25 (Volume 1). It is believed by some students of the problem that the cost of unemployment insurance might serve as an incentive to employers to stabilize their individual businesses, keeping production adjusted to a more uniform pace from month to month and year to year. However, this would likely be true only if the premiums charged were related to the volume of unemployment in a given business establishment, with low premiums for those who have but little unemployment. If the rates paid were dependent upon the frequency of the periods of unemployment and the duration of such periods, it would appear to be to the best interests of employers to iron out the inequalities in their production curves and attempt to avoid serious business fluctuations.

Still another proposal relates to providing jobs for men who are thrown out of employment in times of business depression. We saw, in our study of the problem of unemployment, that the states, with the assistance of the federal government, have established public employment agencies

⁶ Charles F. Roos, editor, *Stabilization of Employment*, Bloomington, Indiana, The Principia Press, Inc., 1933, pp. 103, 104.

for the express purpose of securing employment as promptly as possible for workers who are laid off in time of business depression. It would seem that there is room for a further development of agencies of this kind for putting unemployed workers in touch with employers who, even in periods of depression, sometimes experience difficulty in finding exactly the men they need to fill certain jobs.

But since there is no immediate prospect of eliminating business depressions and wiping out unemployment, and since (as we pointed out in Chapter 2) human needs are ever-present irrespective of the means of satisfying them, society as a whole must be prepared to relieve the suffering that is imposed by involuntary idleness. At the outset of the post-1929 depression, President Hoover urged that relief be handled through "neighborly giving." There was considerable feeling on the part of many that the state, as such, had a responsibility in this matter; and as the depression wore on and private agencies of relief proved unequal to the task, both state and federal governments were called upon to contribute the hundreds of millions that were required to prevent hardship. The extensive grant of public aid to the unemployed was something of a new departure, but this method of handling relief is likely to be used widely in future depressions, since it appears to represent an advance over private charity in several respects. It seems, first of all, to be the only way of getting promptly the large amounts required to rob a great depression of the threat of starvation. Second, it distributes the burden of relief more equitably than private charity, by securing funds by means of taxation and presumably on the basis of "ability to pay." Finally, it smacks less of charity than private giving, and at least implies an acknowledgment, on the part of the government, of responsibility to provide for the involuntarily unemployed who are idle not because of laziness but because society has failed to develop an economic order in which every man who is capable of doing productive work can find a job.

The Problem of Incomplete Liquidation.—This chapter must be brought to a close without the presentation of a cure for business depressions; for, humiliating as the confession is, it must be admitted that there is no certainty that business men, statesmen or economists have as yet found the cause of or the remedy for the cyclical changes in business activity which we have been discussing. It would appear, however, that in at least one respect the post-1929 depression was handled unwisely. Mr. Hoover began, and Mr. Roosevelt continued, the policy of lending financial aid to business organizations which were in trouble, hoping to enable them to stave off bankruptcy and continue in business. What was apparently overlooked was the fact, often pointed out by economists, that a thoroughgoing liquidation is probably the best basis upon which to build prompt and sound recovery.

When businesses go into bankruptcy and are thus completely liqui-

dated, society does not ordinarily lose the productive capacity of these businesses. What happens is that the businesses are usually reorganized, sometimes passing into new hands, but in any event with readjustments made in certain costs which enable them again to produce and sell goods, even though the selling prices of their products have dropped materially with the decline in the general price level. No business can be expected to renew operations or to go once more on a full production schedule unless there is a prospect of at least covering the costs of production. But in some instances that prospect has been eliminated by the loan of government funds, which has allowed concerns to avoid liquidation and thus to escape the compulsory readjustment of costs of production, so that for months or years profitable operation has been out of the question.

Liquidation has been likened by some writers to a surgical operation—unpleasant to contemplate, to be sure, but sometimes necessary if the patient is to regain his health and strength. Some of our American business concerns have been dosed with palliatives, which are easy enough to take but do not seem to have been the type of treatment indicated by the seriousness of their ailment. Enforced liquidation is hard on those who have capital invested, since it means that they must take losses, but the failure to liquidate is hard on all members of society if, as seems probable, it means a delay in moving onward to the period of recovery. Following a policy of "painless depression" for capitalists may be an exceedingly painful procedure for everyone else.

The Possibility of Recovery Through Inflation.—A possible alternative to liquidation is what is sometimes called "inflation" and again "reflation," which means a general upward movement of the price level until it reaches a point at which prices are again at least high enough to permit liquidated concerns to make goods and, despite their high costs of production, sell them to advantage. This appears to have been the plan in the mind of President Roosevelt, but since his first inauguration in March, 1933, the price level has not risen sufficiently fast or far to bring about the desired results. There are many observers who believe that such a rise in general prices, *especially if brought about through the issuance of large quantities of paper money*, would be far more painful to society in general than a complete liquidation of businesses which have been bolstered up by government loans. For inflation of this type, once well under way, is difficult, if indeed not impossible, to stop, and might lead to an intolerable skyrocketing of prices such as was experienced in post-war Germany. We have seen in the chapters on money and banking that the President has the power to issue a fairly large amount of money, on the basis of which a tremendous amount of credit *might* be extended. But whether it *would* be extended would depend upon whether business men wanted it and bankers were satisfied with the security offered them by borrowers.

Hence, even when the stage is all set for an extensive inflation of credit, it is by no means certain that the actors—the business men and bankers—will consent to play the part of puppets in the proposed drama of rising prices.⁷ If the President were empowered to print unlimited quantities of fiat money, there would be no question of his ability to send prices up speedily and to lofty heights; but that power has not been granted him, and would probably not be exercised if he had it, if we may judge from his attitude toward fiat money during the past decade. In the absence of thorough liquidation on the one hand, and of inflation on the other, business recovered but slowly from the post-1929 depression, since there was only a limited demand for goods at prices which were sufficiently high to cover costs of production. The huge demand for war supplies to carry on the second World War provided the impetus which moved the country definitely into the period of prosperity.

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1. What is a "business cycle"?
 2. Explain the significance of Fig. 52. Just what does this chart represent?
 3. Why might the production of a country be expected ordinarily to increase in volume from year to year?
 4. Contrast the irregular production curve in Fig. 52 with the "trend" curve that appears in the same figure.
 5. How long does a business cycle last?
 6. In which years during the past two decades have we suffered seriously from decreased production? Which have been "boom" years?
 7. Why is there a tendency, following a "slump," for production to strike a new high level of activity, instead of merely regaining the lost ground?
 8. Name the "periods" of the business cycle in the order of their occurrence.
 9. Give the characteristic features of each period of the business cycle.
 10. What is the central idea of the "self-generating" theory of business cycles?
 11. Explain the significance of the term "self-generating."
 12. "Each period of the business cycle is the result of certain causes which have developed in the preceding periods of the cycle." What are these "causes"?
 13. Why should "recovery" grow out of a business depression?
 14. Would society be better off if business were stabilized? Why or why not?
 15. How do you account for delays in seeking a remedy for business cycles?
 16. Since the wage earners usually suffer greatly from cyclical fluctuations in business activity, why do they not see to it that the irregularities in production are smoothed out?
 17. Is there any reason why business men should not wish to have business stabilized? Explain.
 18. How might the Board of Governors of the Federal Reserve System help to stabilize business?
 19. How may changes in price levels lead to instability in business activity?
 20. Explain the proposal to lessen unemployment during business depression by the development of public works.

⁷ See, in this connection, R. A. Young, *The New Monetary System of the United States*, New York, National Industrial Conference Board, 1934.

21. What other measures for relieving unemployment are mentioned in this chapter?
22. Why should incomplete liquidation interfere with recovery?
23. How might "reflation" lead out of depression into recovery?

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that arrange for (let us say) shipments of coffee from Brazil to France, and of textiles and cutlery from England to Chile. When we speak, in later paragraphs, of the foreign trade of the United States or of some other country, it must be understood that the expression is one of convenience rather than exactness, and that it is used to indicate trade between individuals located in different countries and not between the governments of two or more countries.

Trade takes place, unless restricted artificially as by a tariff, whenever buying and selling appear to business men to be advantageous. And foreign trade, like domestic trade, is advantageous whenever (as must always be the case in a free trade) each party to the transaction gives up something that he prizes less highly than that which, through the process of exchange, he receives for this item. Whether the exchange takes place between two or more residents of a small secluded village; or between business men of widely separated states, such as Maine and California; or between the citizens of different nations, the fundamental principles of trade are bound to apply.

Some Complicating Features of International Trade.—In several respects, to be sure, international trade differs from domestic trade. There are differences in customs of the people, in language, in monetary units, and frequently in tariff regulations. These several items of difference have little or nothing to do with trade that is carried on within a single country, but they often have the effect of complicating trade transactions which go beyond national boundaries.

FOREIGN TRADE OF THE UNITED STATES

We may now give some little attention to the nature of the trade carried on between the people of the United States and those of other countries. In Table 42 are listed certain important transactions in the international trade of the United States for the year 1940. The sixteen items shown in this table give a fair notion of the transactions which enter into the foreign trade of this country. We shall examine these several items briefly.

1. **Merchandise.**—Most people, in thinking of foreign trade, have in mind shipments of material goods. Though the significance of such goods in international trade is usually exaggerated by persons unfamiliar with the true situation, merchandise is indeed ordinarily the most important single item of American foreign trade. About 45 per cent of the export and 30 per cent of the import items of the United States consisted, in 1940, of merchandise. Some of the specific commodities of which these exports and imports were composed will be noted later. For the present, we may observe that such things as the sales of bunker coal and oil to foreign vessels, ship repairs, and several other items are included among the more usual types of merchandise. Much of the exports of

TABLE 42.—BALANCE OF INTERNATIONAL PAYMENTS OF THE UNITED STATES,
1940

(Source: United States Department of Commerce)

Classes of Transactions	<i>Credits^a</i>	<i>Debits^a</i>	<i>Difference</i>
	Cash Claims Due U. S. from Foreigners (Millions of Dollars)	Cash Claims Due Foreigners from U. S. (Millions of Dollars)	("+" means balance due U. S.) (Millions of Dollars)
1. <i>Merchandise</i>			
We sold commodities amounting to.....	4021		
We bought commodities amounting to.....		2625	+ 1396
<i>Service Items</i>			
2. <i>Freight and shipping:</i>			
We received from foreigners for such services..	223		
We paid foreigners for such services.....		327	- 104
3. <i>Tourist expenditures:</i>			
Foreign tourists spent in the United States....	81		
American tourists spent abroad.....		223	- 142
4. <i>Immigrant remittances:</i>			
New immigrants brought into the United States	30		
Immigrants in the U. S. sent "back home"...		120	- 90
5. <i>Interest and dividends on private investments:</i>			
We received from foreigners.....	525		
We paid to foreigners.....		215	+ 310
6. <i>Government transactions:</i>			
Foreign governments paid the United States..	28		
United States government paid foreigners....		122	- 94
7. <i>Miscellaneous services:</i>			
We received from foreigners for such services..	164		
We paid foreigners for such services.....		66	+ 98
8. <i>Contributions:</i>			
We gave to foreign causes.....		55	- 55
<i>Capital Movements</i>			
9. <i>Long-term investments:</i>			
Net balance.....		53	- 53
10. <i>Changes in international banking accounts:</i>			
Net inflow of banking funds to United States..	873		+ 873
11. <i>Advance payments by British government.....</i>	720		+ 720
12. <i>Miscellaneous capital items.....</i>		170	- 170
<i>Gold, Silver, and Paper Currency</i>			
13. <i>Gold:</i>			
Exports from United States.....	5		
Imports to United States.....		4749	- 4744
Earmarking operations (net).....	645		+ 645
14. <i>Silver:</i>			
Exports from United States.....	4		
Imports to United States.....		59	- 55
15. <i>Paper currency movements:</i>			
Net inflow to United States.....	33		+ 33
16. <i>Other transactions.....</i>	1432		+ 1432
	8784	8784	....

^a Credit transactions are those which may be expected to result in payments into the United States; debit transactions are those which will result in payments from the United States to foreign countries.

the United States in 1940 consisted of war supplies or "strategic commodities" sent to the United Kingdom and other parts of the British Empire. It has been customary, in the past, to regard silver as an article of merchandise; but the increasing importance of silver shipments in American foreign trade in recent years has led to its being given a separate listing. Silver appears in our table under Item 14.

2. **Freight and Shipping.**—Freight charges entering into foreign trade consist of items arising out of ocean, Great Lakes, and land transit. Ocean freight includes American merchandise carried in vessels owned by foreigners, and foreign goods transported in American bottoms. A foreign trade situation exists also in connection with traffic on the Great Lakes, in which commodities are moved from the United States to Canada, and vice versa. In addition to freight hauled by water, goods transported by rail sometimes enter into international trade. Great quantities of Canadian grain are carried by American railroads from the Great Lakes (usually from Buffalo) to the Atlantic seaboard. An even larger item is that charged by Canadian railways for carrying American lumber, grain, and packing-house products, which in many cases are reshipped from Vancouver or Montreal. Table 42 shows that, in 1940, we paid foreigners \$104,000,000 more for freight and shipping than we collected from them for this type of service.

3. **Tourist Expenditures.**—Expenditures of tourists in foreign countries are also included in the international balance sheet. The expenditures of Americans traveling abroad appear as "debits," and those of foreigners in this country as "credits." It is estimated that in 1940 American tourists spent \$223,000,000 in foreign countries, as against \$81,000,000 spent by foreign tourists in the United States. This is 60 per cent less than was spent for similar purposes in 1937, and this reduction is attributable to uncertain world conditions which tend to discourage foreign travel. Departures from the United States to European and Mediterranean destinations fell from 135,000 in 1939 to 16,000 in 1940. "Canadian-American tourist traffic involves a larger total expenditure than that between any other two countries in the world,"³ but there were only 80 per cent as many United States visitors to Canada in 1940 as in 1939, and the number of Canadian visitors to the United States fell off almost 50 per cent. Americans, as is well known, do a great deal of traveling, a fact which may be explained in part by the large per capita wealth of the United States. Expenditures of foreign tourists in this country are ordinarily about one-quarter as great as those of American travelers in other parts of the world.

4. **Immigrant Remittances.**—Many immigrants who have come to the United States during the past few decades have left behind them in

³ United States Department of Commerce, *Trade Information Bulletin No. 625*, Washington, Government Printing Office, 1929, p. 11.

their "old countries" relatives who are partly dependent upon them. From their earnings in this country (which are usually much larger than the incomes to which they have been accustomed in their native lands), these immigrants have frequently remitted considerable sums to their dependents. Remittances of this kind account for a "debit" item of \$120,000,000 in Table 42. The small offsetting item of \$30,000,000 appearing as a "credit" consists of cash brought into the United States by immigrants entering this country in 1940.

5. **Interest and Dividends on Private Investments.**—When capital funds seek investment in foreign countries, they do so for the reason that investment opportunities abroad appear to be more advantageous than those at home. The investments are made, of course, with the idea of receiving an income from the securities that have been purchased, and this income forms an item of international trade. American private investments abroad have been placed chiefly in Latin America, Europe, and Canada. Interest on such investments amounted in 1940 to about \$525,000,000, and the foreign holders of American securities received, in that year, interest payments totaling \$215,000,000.

6. **Government Transactions.**—We have already noted the fact that foreign trade is usually conducted between individuals and not between governments. But in some instances governments buy from other governments. Credits and debits of this kind in 1940 included (a) net receipts from Panama Canal operations, (b) expenditures abroad by the various executive departments, (c) remittances by the Veterans' Administration, and (d) cost of foreign representation in the United States and United States representation abroad.

Between 1923 and 1930, this country received more than \$200,000,000 annually as principal and interest payments on the huge sums borrowed by our Allies in the first World War. But these payments declined steadily after 1930, and stopped entirely shortly after the beginning of the second World War. In 1940, our government paid other governments \$94,000,000 more than it received from them.

7. **Miscellaneous Services.**—Grouped under the heading "Miscellaneous services" are imports and exports of electric power; magazine and newspaper subscriptions; disbursements for advertising; cable, radio, and telephone services; royalties on motion pictures, and so on. In the case of miscellaneous, as in other international transactions, there are both "credits and debits." For the year 1940, as is shown in Table 42, transactions of this kind resulted in a net balance of \$98,000,000 due the people of the United States from foreigners.

8. **Contributions.**—Total contributions made to foreign fields of activity by United States charitable, religious, educational, and scientific institutions during 1940 are estimated at \$55,000,000 on the basis of data submitted by 125 organizations.

9. **Long-term Investments.**—Citizens of the United States have made investments abroad for many years, and American securities have been bought by foreigners who, for one reason or another, have wanted to invest their funds in this country. Year by year these investments are increased through purchases of foreign bonds and stocks, or reduced by sales of such securities or by the payment of matured bonds. In 1940, the purchases of long-term foreign securities by Americans and the sales of American securities to foreigners resulted in a net balance of \$53,000,000 due the people of other nations.

10. **Changes in International Banking Accounts.**—It is quite common for banks to have deposits with banking institutions of other countries; largely for the purpose of paying balances arising out of international trade. There has also been an extensive development of commercial short-term loans in foreign countries. A recent government statement showed that American deposits and short-term loans with foreigners amounted to \$137,000,000 at the end of 1940, while similar foreign deposits and loans in America reached the huge total of \$3,980,000,000. This represents a reversal of the situation that existed in 1933, when the figures were, respectively, \$1,082,000,000 and \$487,000,000. The net change in America's international deposits and short-term loans for the year 1940 was \$873,000,000.

The flow of short-term funds from foreign countries to the United States, during the past decade, has been in part the return from foreign money markets of American-owned banking funds, and in part a flight of foreign capital to the United States which was stimulated by political and financial uncertainties in Europe and elsewhere. This inflow of funds affected the trade balance in recent years in exactly the same way as though merchandise to this amount had been sent out of the United States.

11. **Advance Payments by the British Government.**—In order to facilitate the production and purchase of war supplies in the United States, Great Britain (and also France) made some payments considerably in advance of the export of goods and provided capital assistance to certain producers where new plant facilities were needed. This item of \$720,000,000 represents payments of these kinds.

12. The United States Department of Commerce includes under this heading certain capital items which are not explained in detail.

13. **Gold.**—Gold is shipped from country to country for use in the arts, to settle the balances of international indebtedness (as will be explained in the following chapter), and to serve as reserves in the vaults of central banks of various countries. In some cases the central banks are allowed to retain their holdings of gold abroad, and yet have such gold count as reserves if it is segregated and marked in such manner as to indicate that the identical coins or bars "earmarked" are the bank's

property, and altogether subject to its disposal. It is not the practice of the Federal Reserve banks to count as reserve any gold held abroad; but when they have come into possession of gold abroad at a time when they held ample gold at home, they have sometimes had it earmarked there, largely in order to save expense of shipping to the United States gold that might later require reshipment. Earmarked gold belonging to an American bank but held temporarily in a foreign bank is set aside to await instructions from the American bank, and cannot of course be used except upon specific order from the bank that owns it.

Since the Munich conference of September, 1938, the flow of gold to the United States has been greatly accelerated. In 1939 and 1940, the net gold imports to this country exceeded the gross merchandise exports—a situation without precedent in the history of the United States. Transactions in gold, including foreign shipments and earmarking, resulted in 1940 in a net “debit” of \$4,099,000,000. Gold exports amounted to only \$5,000,000, net earmarkings equivalent to exports of \$645,000,000 took place, and gold imports totaled \$4,749,000,000. This tremendous importation of gold, which established a new high record for gold shipments to the United States, was influenced largely by political and economic unsettlement throughout the world. Most of this gold came from the British Empire. “Shipments have been greatly in excess of production for several years,” observes the Department of Commerce. “There is good reason to believe that many of the principal gold stocks have already been transferred for the most part to the United States.”

14. **Silver.**—Influenced greatly by United States Treasury purchases, in accordance with the provisions of the Silver Purchase Act of 1934, we imported \$355,000,000 worth of silver in 1935, \$183,000,000 worth in 1936, and \$92,000,000 worth in 1937. In 1940, we imported only \$59,000,000 worth of silver, the lowest imports of this kind since the Silver Purchase Act went into effect. Since we exported \$4,000,000 worth of silver in 1940, we had a net “debit” balance of \$55,000,000 on this item for that year.

15. **Paper Currency Movements.**—There is ordinarily found, in every important country, a considerable amount of the paper currency of other important countries. In 1940, a good deal of American paper money which had been abroad was shipped back to this country. Deducting from such receipts the shipments of foreign paper currency out of this country to the countries of issue, we have a net “credit” of about \$33,000,000, which affects the balance sheet as it would be affected by a shipment of merchandise from the United States.

16. **Other Transactions.**—This is a residuum, made up largely of special items which it is not feasible to show separately.

Foreign Trade in Prosperity and Mild Depression.—Since 1940 was a year of moderate business depression, the figures in Table 42 are lower

than they would be if we had chosen a year of prosperity, say 1928. For in 1928 the total "credits" (and therefore the total "debits") on the international balance sheet amounted to \$10,559,000,000. Hence, the foreign trade of the United States in 1940 was only about 83 per cent as great as in 1928. We shall not undertake to examine here the 1928 figures item by item, but we may note the fact that American exports of merchandise in that year totaled \$5,334,000,000, and American imports of merchandise \$4,497,000,000. This means that exports and imports of merchandise in 1940 were, *in terms of dollars*, approximately 75 and 58 per cent, respectively, as important as in 1928. However, since the price level was slightly lower in 1940 than in 1928, the decline in actual *volume of commodities* was somewhat less than the decline indicated by a comparison of the total value of merchandise exports and imports for these two years.

AMERICAN EXPORTS AND IMPORTS OF MERCHANDISE

In 1940, 45 per cent of the export items of the United States, and 30 per cent of the import items, consisted of merchandise, as is shown in Table 42. Twelve years earlier, in 1928, when world trade was being transacted on a more extensive scale, these percentages were 50 for exports and 40 for imports.

We turn now to the consideration of some of the most important articles of merchandise that enter into American foreign trade. In Tables 43 and 44 are listed, respectively, the principal commodities exported and imported by the people of the United States. Two columns of figures are given in each table, the first being a five-year average for 1923-27, and the second for 1940. The five-year average represents more nearly "normal" conditions than do the 1940 figures, since the half-decade that has been chosen includes both "good" and "bad" years, from the business point of view, whereas 1940 was less good than average but was marked by unusually large exports of equipment for use in war.

Merchandise Exported from the United States.—Of the fifteen items that appear in Table 43, five are of special interest because of their large contribution to the volume of total exports of this country. Heading the 1923-27 list is cotton, a commodity in the production of which the United States leads the world. Our five-year average gives to cotton an annual export value of about \$900,000,000, but in some years the figure has been above a billion dollars. However, our cotton sales in the world market are meeting increasingly stiff competition from other cotton-producing countries, and will probably never regain their past pre-eminence. Japan was our best pre-war customer in the purchase of cotton, with England running a fairly close second.

Next in importance in the five-year average are petroleum and petroleum products (such as gasoline, kerosene, and lubricating oils), which

we often export to the extent of approximately a half-billion dollars' worth a year. The export item third in rank, judged by value of product, is machinery of all kinds, including agricultural and industrial implements, office appliances, printing machinery, and so on, with values approximating \$360,000,000. Next in importance are automobiles, and automobile engines and parts. This item is one of increasing significance. Though the average for the five-year period was only \$281,000,000, there had been

TABLE 43.—VALUE OF PRINCIPAL COMMODITIES EXPORTED FROM THE UNITED STATES .
(Source: *Monthly Summary of Foreign Commerce of the United States*, December, 1940)

Classification	Value in Thousands of Dollars	
	Five-year Average, 1923-1927	1940
1. Cotton, raw	891,634	209,231
2. Petroleum and petroleum products	464,313	310,184
3. Machinery, all classes	359,401	605,428
4. Automobiles, including engines and parts	281,515	641,184
5. Wheat, including flour	275,291	34,106
6. Iron and steel products	159,237	588,953
7. Tobacco, unmanufactured	149,588	44,045
8. Copper and copper manufactures	147,090	155,000
9. Animal fats and oils	144,080	13,065
10. Coal and coke	140,517	92,254
11. Cotton manufactures	135,113	60,300
12. Meats	108,725	21,745
13. Sawmill products	101,997	36,781
14. Fruits and nuts	100,355	34,411
15. Rubber and rubber manufactures	51,163	44,410

a steady advance in the exports of automobiles for several years prior to the depression that began in 1929. The figure for 1927, for example, was \$388,000,000. The 1940 exports of machinery and automobiles were almost double the five-year average, because of extensive war-time orders. This is the explanation, also, of the large exports of iron and steel which, in 1940, were approximately four times as great as during the period 1923-27.

The last item of exports which we shall note specifically consists of wheat and flour, which in some years have brought to American exporters payments totaling slightly more than \$400,000,000, and in other years somewhat less than that amount. The United States has been a consistent exporter of wheat, for the country produces regularly more foodstuff of this kind than can be disposed of in the home market. However, the effort of other countries to make themselves more largely self-sufficient in the production of foodstuffs has reduced substantially the

quantity of wheat purchased from the United States by foreigners. The extremely low export of wheat in 1940 reflects this effort.

Our exports of petroleum are made possible, of course, primarily because important oil fields are located within our national boundaries. We are fortunate, likewise, in having land and climatic conditions favorable to the growth of certain agricultural crops. The suitability of the South for cotton production, and almost ideal conditions for the growing of wheat in the Middle West and North West, enable us to raise these crops so advantageously that it pays to produce both cotton and wheat for export. In machinery and automobiles we have commodities that are manufactured on the basis of large-scale production. This is a field of manufacture in which American enterprisers excel; and here, as in the items mentioned above, production is carried on so advantageously that it is profitable to produce not only for the domestic market but for foreign markets as well.

Merchandise Imported to the United States.—In Table 44 the first four items have stood out in most years as exceptionally important from the point of view of import values. The cotton goods manufacturers of England look to the United States for the bulk of their raw material, and

TABLE 44.—VALUE OF PRINCIPAL COMMODITIES IMPORTED INTO THE UNITED STATES
(Source: *Monthly Summary of Foreign Commerce of the United States*, December, 1940)

Classification	Value in Thousands of Dollars	
	Five-year Average, 1923-1927	1940
1. Silk, raw.....	379,980	125,997
2. Rubber, crude.....	326,935	303,118
3. Sugar, cane.....	296,090	127,309
4. Coffee.....	262,463	126,808
5. Paper and paper manufactures.....	128,279	132,618
6. Wool and mohair.....	110,894	84,604
7. Furs and fur manufactures.....	108,804	73,662
8. Petroleum and products.....	105,151	70,110
9. Hides and skins.....	100,078	50,188
10. Copper, ore and manufactures.....	92,239	73,492
11. Tin, including ore.....	86,685	130,981
12. Wood pulp.....	81,879	75,414
13. Fruits and nuts.....	80,745	46,997
14. Cotton manufactures.....	80,739	23,747
15. Sawmill products.....	74,459	24,177
16. Wool manufactures.....	72,354	25,161
17. Burlaps.....	72,176	45,476
18. Vegetable oils and fats.....	71,411	55,838
19. Tobacco, unmanufactured.....	69,834	36,722
20. Fertilizers.....	67,319	27,207

the silk manufacturers of this country have depended upon producers in other countries for the raw silk from which to spin and weave silk cloth. So great was the demand of American manufacturers for raw silk, that average annual silk imports totaled, in 1923-27, almost \$400,000,000 in value. But the encroachment of rayon upon real silk is indicated by the steadily declining imports of raw silk into this country; and, of course, our entry into the second World War put a stop to our imports from Japan, which was formerly the source of most of our raw silk. Another important raw material for which we have depended almost wholly upon other countries is crude rubber. Owing largely to our enormous output of automobiles and motor trucks, and the consequent demand for rubber tires, we have often imported annually from the Malay Peninsula more than \$300,000,000 worth of crude rubber, which is here manufactured into rubber products. In one exceptional year (1926) our imports of rubber amounted to \$500,000,000. Japanese military activities in Malaya in early 1942 led to the strict rationing of automobile tires in the United States, in anticipation of probable interference with trade from this great rubber-producing region.

We produce in the United States a part of the sugar required by our people, but the bulk of this commodity is imported from Cuba. Our average annual imports of sugar in "good times" amount to some \$300,000,000. Most of the imported sugar comes to us in the raw or unrefined state, and is subjected to manufacturing processes in American sugar refineries. Coffee, of course, is an article which we do not attempt to grow in the United States. Instead, we import our coffee from South America (chiefly from Brazil and Colombia), and we pay to foreigners for this commodity a little more than a quarter of a billion dollars annually in years of prosperity.

Raw Materials vs. Manufactures.—Without dealing further with individual items of international trade, we may make the general observation that American exports consist in the main of manufactured goods, and American imports are made up rather largely of raw materials. There are, to be sure, some considerable exceptions to this statement. But the generalization is sufficiently true of present conditions, and it has special significance as indicating a definite trend. At present, approximately 65 per cent of our commodity exports consist of goods partly or wholly manufactured, as against 40 per cent in 1880; and whereas in 1880 we imported only about 20 per cent of our raw materials used in manufacturing, today we import approximately 35 per cent of such materials. We see here an illustration of the well-known fact that America is becoming more distinctively industrial and less distinctively agricultural.

Direction of American Foreign Trade.—Before quitting the subject of American exports and imports of merchandise, we may note briefly the

sources of the imports into this country and the destinations of our exported commodities.

Table 45 gives an idea of the direction of American international trade on the basis of continental divisions. The figures here given are for 1940. To Europe went 41 per cent of our commodity exports in that year, including cotton and other raw materials, foodstuffs, machinery, automo-

TABLE 45.—PERCENTAGE DISTRIBUTION OF UNITED STATES
EXPORTS AND IMPORTS, BY CONTINENTS, 1940

(Source: *Monthly Summary of Foreign Commerce of the United States*, December, 1940)

	Percentage of Total Exports	Percentage of Total Imports
Northern North America.....	18.0	16.6
Southern North America.....	8.5	9.7
South America.....	10.8	15.0
Europe.....	40.9	14.8
Asia.....	15.4	37.7
Oceania.....	2.4	1.3
Africa.....	4.0	4.9

biles, and so on. Economically, Europe is essentially a manufacturing region, and yet Europeans normally buy a large quantity of American manufactures, which are attractive because of high quality and low prices. Manufactured goods make up about one-half of our usual exports to Europe, the other half consisting of raw materials.

About 26 per cent of our exports in 1940 were sold to our neighbors in North America. Two-thirds of these commodities were manufactured goods. Asia, our next best customer, took almost 50 per cent more of our goods than South America, our third best. Nearly 60 per cent of our sales to Asia were of manufactured goods, while "semi-manufactures and finished manufactures" made up about 95 per cent of the goods exported to South America, Oceania, and Africa.

In imports, Asia headed the list in 1940, sending us nearly 38 per cent of all commodities brought into this country. Fifty-five per cent of these goods were raw materials, of which rubber was the most important single item. Europe ordinarily comes second in sending merchandise to the United States, but the second World War so greatly reduced our 1940 imports from Europe that North America (with 26 per cent) and South America (with 15 per cent) took second and third places, respectively, in that year. Three-fourths of the goods usually bought in Europe by Americans are manufactures, a fact which attests the industrial activity of that continent. United States imports from North America are chiefly from Canada, Cuba, and Mexico. Three-fourths of these purchases are of

manufactured goods. The imports from South America, on the other hand, consist of raw materials to the extent of four-fifths of the total. Coffee from Brazil and Colombia, wool from Argentina, and nitrates from Chile account for the bulk of these imports. Oceania and Africa are relatively unimportant in the matter of exports from and imports to the United States.

GAINS THROUGH INTERNATIONAL TRADE

Trade, as we have so often said, consists of the exchange of surpluses that arise from the practice of specialization. International trade is the result of geographical or territorial specialization. It is specialization pushed beyond national boundaries. Nowhere are the benefits of specialization more clearly seen than in foreign trade. This is particularly true in the case of certain materials which depend upon favorable climatic conditions if they are to be produced with small effort. Sugar, coffee, cotton, rubber, and several other commodities fall within this group. Since they may be grown with slight expenditure of capital and labor in some parts of the world, but in other regions only at great cost, if indeed at all, it is obviously advantageous to resort to specialization and exchange in the production of such goods.

Success in Relation to Natural Endowments.—It is generally recognized that success is most likely to attend the efforts of the individual who engages in the type of work for which he is best fitted by nature. Messrs. Dempsey and Tunney probably achieved greater success in the pugilistic ring than they could have hoped for in academic circles; and, in like manner, our college professors doubtless do well to confine their efforts to things academic rather than to venture into the prize-fighting game. It is equally true that a nation is most likely to prosper economically if it applies its energies to the type, or types, of production in which it is able to engage most efficiently.

Two Important Advantages of Foreign Trade.—In dealing with the benefits of international trade we shall speak from the American point of view, though the choice of country makes no difference, of course, in the principles involved. In general, the people of the United States gain through foreign trade in that they are enabled, by reason of this trade, first, to enjoy some goods of which they would otherwise be deprived; and, second, to secure other commodities at lower prices (or at least to *greater advantage*) than if the goods were produced in this country.

The Enjoyment of Exotic Products.—The first of these gains is fairly apparent. It is true that bananas, coffee, and the like might possibly be grown in the United States under glass. But we know that, without any question, production carried on under such conditions would be highly disadvantageous and would result in prices so excessively high that

they could not be paid by the average citizen. Consequently, we are justified in saying that international trade brings to us certain goods which, in the absence of such trade, we should not be able, as a people, to procure.

The Principle of Comparative Costs.—The second gain noted above is somewhat less obvious; and yet a tremendous amount of foreign trade is carried on, not because in its absence a country would be compelled to get along without desirable goods, but rather for the reason that, in the output of an article that could be produced in two countries, it is often advantageous for one country to defer to the other. That is, the country that is less favorably equipped for a special kind of production yields to the country that is particularly well prepared to turn out the goods in question. This latter country thus specializes in making the article, producing enough not only for itself but for the other country as well, with the result that both benefit by the arrangement.

Absolute Advantage.—This principle, which is known as the principle of comparative costs, is readily understood when the advantage is *absolute*, but it is more difficult to see in a case of *comparative* advantage. It is clear, for example, that it would be wise for the experienced banker to concentrate upon the problems of banking, and for his stenographer to specialize in typing and similar work. The point is that each is, in his or her particular field of endeavor, more skillful than the other; and it would be wasteful for the stenographer to take a turn at money and credit while the banker pounded the typewriter. The latter is more productive when specializing in money matters than in the rôle of typist; and the stenographer is more productive in her field of specialization than in determining upon the placing or calling of loans.

By the same token, Brazil is more effective than the United States in the growing of coffee, and this country is more productive than Brazil in the manufacture of farming implements. In this instance, it is said that Brazil has an absolute advantage in the production of coffee, and the United States an absolute advantage in the production of farm machinery. In cases of this kind, it is clearly the part of wisdom for these countries to engage in foreign trade, so that the United States may get her supply of coffee, and Brazil her farming implements, at lower prices than would prevail if the two nations attempted to practice self-sufficiency.

Comparative Advantage.—But (reverting to our former illustration) let us suppose that the banker is himself an expert typist and is able to operate the typewriter so skillfully as to exceed the speed of his stenographer. In this instance, he would have an *absolute advantage* in both banking and typing. Should he, then, undertake to act as his own typist, or should he allow his stenographer, who is a less skillful typist than he, to write his letters and other papers? The common-sense answer is that

the typing should be delegated to the stenographer; for, though the banker is more productive than the stenographer in both banking and typing, yet he is more productive as a banker than as a typist. Therefore, it will pay him better to concentrate upon banking and allow another to do his typing. Because of the specialization of the banker in the field which is for him most productive (namely, finance), the stenographer is said to have a *comparative advantage* in typing.

Consequences of Comparative Advantage.—We find that a great deal of international trade depends upon advantages of this latter type. So fortunate is the United States in the matter of natural resources, efficient management, and competent labor, that it is able to produce a great many commodities at an absolute advantage. But its advantage in the production of a limited number of articles is so great that in some instances it willingly surrenders absolute advantage in one form of production in order to embrace more fully a still greater absolute advantage in another.

These items that are neglected by us are then produced at a comparative advantage by other countries, which are thus able to engage in trade with the United States; and both countries gain in the process. It is claimed, for example, that we could produce flax quite as advantageously as any country in the world. But our facilities for growing other agricultural crops are so pronounced (and so superior to our advantages for the raising of flax), that, so far as agriculture goes, we have usually specialized in cotton, wheat, and other farm products, and imported our flax from Russia and Belgium.

Effectiveness of Productive Effort.—Whether the advantage enjoyed by a nation is "absolute" or "comparative" does not matter particularly. The important thing is that the people of a country should, from the economic point of view, always engage in those types of production in which their efforts will be employed most effectively. In some economic activities, the laborers of one country may be much more productive than those of another. In the mining of coal, for example, the coal workers of the United States are much more productive than the coal workers of England. It does not follow from this fact that no coal should be mined in England; but if there are other industries in which England has an absolute advantage over the United States, or in which she suffers a smaller disadvantage (enjoying, therefore, a comparative advantage), Englishmen would do well to concentrate upon these industries and leave the mining of coal to the laborers of the United States.

Some Reasons for Productive Superiority.—In suggesting that labor is more productive in some countries than in others, a word of caution is necessary. The expression is not used with the thought of implying that this superiority results from greater industry or skill on the part of the workers, though this might, indeed, be the case. But it is probable that

the greater productivity comes more often from conditions other than the workers' greater skill and aggressiveness. In the case of coal mining cited above, the American worker produces more than twice as much per day as the British worker. But if the American miner were put to work in British mines, it is likely that his productive superiority would immediately disappear. For this superiority is due chiefly, and perhaps wholly, to the greater thickness and accessibility of coal seams in the American mines and to the employment of more mining machinery here than in Great Britain. Advantages, "absolute" or "comparative," do sometimes result from exceptional intelligence and skill on the part of labor. But probably more often they are attributable to natural resources or climatic conditions, to the great abundance of capital of modern type, to exceptionally able management, or to a combination of several of these factors.

The gains of foreign trade, then, are similar to the gains of domestic trade. Through geographical specialization, as through individual specialization, the total product is increased. By creating and exchanging surpluses of specialized goods, individuals are enabled to secure more commodities and services than would be available without specialization. If this is true of individuals within a country, it is equally true of individuals in different countries; and foreign trade, as was pointed out at the beginning of the chapter, is almost wholly trade between individuals and not between nations.

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1. In what respects are domestic trade and foreign trade similar? In what respects are they dissimilar?
 2. Does the expression, "the foreign trade of the United States," refer to trade of this government with other governments?
 3. What was the total amount of foreign trade (expressed in dollars) of the United States in 1940, as shown in Table 42?
 4. What part of our total foreign trade consists of merchandise transactions?
 5. Which are greater, our exports or imports of merchandise?
 6. Why should gold be shipped from country to country? How does "ear-marking" lessen the amount shipped?
 7. How do you explain the fact that the American item of "tourist expenditures" is much larger than the item indicating foreigners' tourist expenditures in this country?
 8. Name the five principal exports of the United States, giving some idea of the value of each.
 9. What is there about our productive abilities that makes it possible for us to export these five items in large quantities? Examine each item separately in answering this question.
 10. Name the four principal imports to the United States, giving some idea of the value of each.
 11. From what regions do these four commodities come? Would you classify them as "raw materials" or "manufactured goods"?

12. It is said that the United States is becoming more distinctively industrial and less distinctively agricultural. Illustrate with items entering into foreign trade.
13. Upon what geographical regions are we chiefly dependent for our imports?
14. What geographical regions are the leading purchasers of American exports?
15. What is the relationship between international trade and specialization?
16. What are the two great advantages of foreign trade?
17. "In the output of an article that could be produced in two countries, it is often advantageous for one country to defer to the other." Why?
18. Give an example of "absolute advantage" as it may be seen in production by two countries.
19. Give an example of "comparative advantage."
20. In the manufacture of many kinds of goods, American workers are "more productive" than the workers of other countries. Why?

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CHAPTER 39

THE SETTLEMENT OF INTERNATIONAL OBLIGATIONS

FOREIGN EXCHANGE

WE TURN now to one of the complications of international trade which has to do with making payment for goods imported and receiving payment for goods exported. The difficulty in effecting these payments arises partly from differences in the monetary units used in two countries—but it is also due, in part, to the distances involved.

Payments in Long-distance Trade.—The first of these items does not, of course, affect domestic trade. But the second may prove to be something of a problem within a country of great size. In trade between Massachusetts and California, for example, there is the necessity of making and receiving payment. If a Boston shoe manufacturer sells his product to a San Francisco merchant, he probably receives in payment a check payable at a San Francisco bank. This check he deposits in his own bank in Boston, but the Boston bank must in some way collect from the bank in San Francisco. Prior to the introduction of the Federal Reserve System, a charge was made for this service, theoretically to cover the cost of gold shipment from California to Massachusetts and loss of interest during the period of transport, though in reality the actual gold was seldom transferred. Check collections of this kind are now made without charge, through the Federal Reserve banks, by means of the gold settlement fund (which was described in Chapter 33), so that the payment of long-distance domestic obligations no longer constitutes a real problem.

Gold as International Money.—In international trade some of the difficulties due to differences in monetary units have been disposed of in normal times by expressing international obligations in terms of gold. Though British paper money would not be acceptable to an American exporter of cotton since it could not be used in ordinary business transactions in this country, gold to the proper amount is quite welcome, because it can be converted readily, and without loss, into American dollars upon application to the United States Mint. In like manner, American gold is acceptable in foreign countries operating on a gold standard. What we are saying, then, is that gold, because of its desirability as a commodity, is generally acceptable and serves as money practically throughout the world.

Avoidance of Gold Shipments.—It would be highly undesirable, however, to make payment for all international transactions in actual gold. An arrangement of this kind would have meant in 1940 the shipment of about \$17,500,000,000 worth of gold to take care of the trade transactions between the United States and other countries, as may be seen by examining Table 42. In 1929, when foreign trade was greater than in 1940, the figure would have been some \$21,000,000,000. Fortunately, there is no need to make such huge shipments, for in foreign trade, as in domestic trade, business transactions tend to offset one another. It is a truism in international trade that, over a long period of years, a country cannot sell goods unless it will buy; that is, it cannot hope to engage in export trade unless it is willing also to import goods from other countries. This is a matter into which we shall inquire shortly.

Economy in the Use of Gold.—Table 42 shows that in 1940 the foreign trade of the United States consisted of exports and imports amounting to some \$17,500,000,000. Of this amount, gold movements came to \$4,754,000,000, or 27 per cent of the total. We have seen that this was a highly abnormal year in the matter of gold shipments, since foreigners sent large quantities of gold to the United States in the interests of safety. Hence, we shall understand better the rôle played by gold in international trade if we consider a year of both peace and prosperity. In 1928, for example, less than \$1,000,000,000 worth of gold changed hands in carrying out \$21,000,000,000 worth of international business transactions. The reason so huge a volume of trade can be transacted with so slight a movement of gold is that, just as in the clearing houses of our banking system, claims are set over against claims, debits against credits, and thus most obligations are canceled without necessitating the shipment of gold.

The general principle involved in the cancellation of debits and credits arising in international trade may be made clear through a very simple illustration. Let us suppose England and the United States to be on the

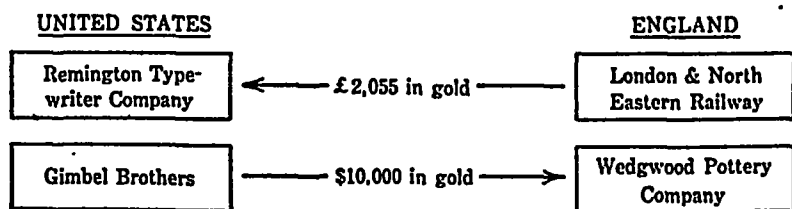


FIG. 53.—SETTLEMENT OF INTERNATIONAL OBLIGATIONS BY GOLD SHIPMENTS

gold standard, as they were prior to 1931, with no governmental restrictions upon the shipment of gold. Now if, under these conditions, the Remington Typewriter Company sells \$10,000 worth of typewriters to the London and North Eastern Railway, and at about the same time the

Wedgwood Pottery Company ships a £2055 order of china to Gimbel Brothers of New York, there are several possible ways of settling these obligations. With our assumption of £1 sterling being equal to \$4.87, as in 1931, the value of the shipment of typewriters would equal exactly the value of the shipment of china. Hence, the shipments of goods might be paid for by the shipment of gold, as shown in Fig. 53.

The Cancellation of International Obligations.—But it is troublesome and costly to ship gold to England from the United States, and to the United States from England. We may be sure that these importers, whose problem it is to effect payment, would try to avoid an actual transfer of gold. This would be fairly easy if all four parties concerned were acquainted with one another and knew of the sales that had taken place. In such event it could easily be arranged that Gimbel Brothers should pay \$10,000 to the Remington Typewriter Company, and the London and North Eastern Railway Company a like sum in British money (£2055) to the Wedgwood Pottery Company. Through a canceling-out process of this kind both obligations could be met without the use of gold. The transaction would be as in Fig. 54.

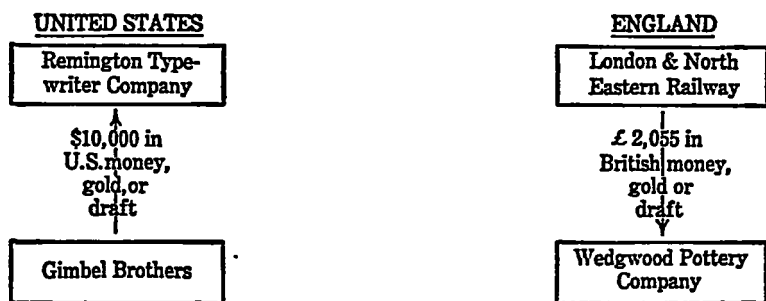


FIG. 54.—SETTLEMENT OF INTERNATIONAL OBLIGATIONS BY CANCELLATION

This is, fundamentally, the financial transaction that takes place in the settlement of obligations arising in foreign trade, but the process is not quite so simple as it appears above. Our illustration is based upon two assumptions that we cannot make with safety, in addition to the hypothesis that there is no governmental restriction to the free shipment of gold between these two countries. The first is that the parties engaging in international trade know of each other's business dealings with foreigners; and this is certainly a far-fetched notion, in view of the large number of persons engaging in such trade. The second assumption, that transactions of exactly equal amounts (in the present case, of \$10,000 each) can be located and canceled out, is likewise not warranted.

The Use of "Foreign Exchange."—For these and other reasons, there has come into existence a class of middlemen who are bankers or private dealers in "foreign exchange" (the name given to foreign drafts

or bills of exchange). The introduction of these bankers into the situation removes the difficulties we have just described. Their presence in the field makes it unnecessary for exporters and importers to know one another, for these bankers provide a recognized market in which exporters can sell their claims against foreigners, and importers can purchase bills of exchange with which to pay obligations due foreign exporters. There is the further fact that these dealers in foreign exchange, like commercial bankers, exchange bank credit for personal credit, and thus render it more generally acceptable.

The entrance of the banker into the picture gives us a situation such as is shown in Fig. 55. The Remington Typewriter Company, wishing to

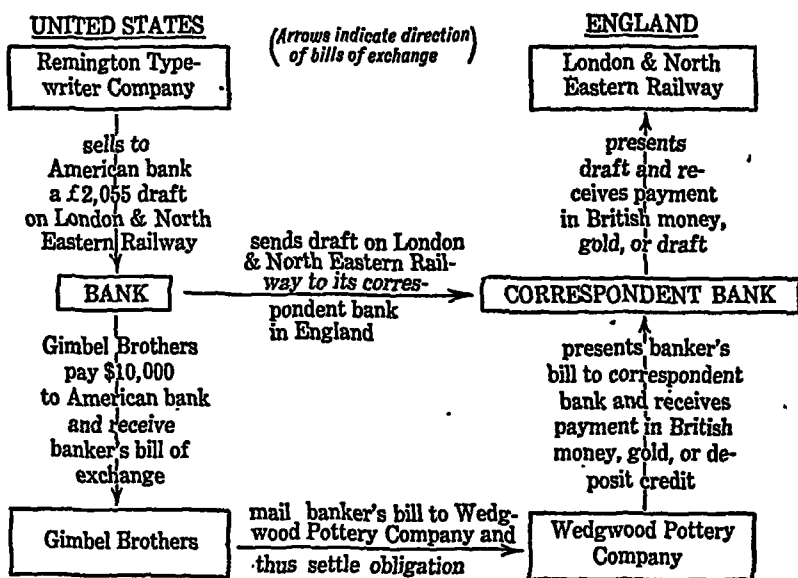


FIG. 55.—THE USE OF "FOREIGN EXCHANGE"

secure payment at once, sells to a New York bank (dealing in foreign exchange) a draft or commercial bill ordering the London and North Eastern Railway to pay the Remington Typewriter Company £2055, or its equivalent in gold. This sale of the endorsed draft gives the Remington Typewriter Company immediate possession of the \$10,000 due this concern; and the bank proceeds to collect the draft by sending it to a correspondent bank in London, which in turn presents it to the London and North Eastern Railway Company and receives payment in British money. Gimbel Brothers, on the other hand, buy from the bank a banker's bill of exchange for £2055, which it forwards to the Wedgwood Pottery Company; and this concern, by presenting the bill at the correspondent bank, secures payment for the shipment of china to the Gimbel store. Here, again, all claims have been settled without transfer of gold overseas.

"Foreign Balances" of Dealers in Exchange.—We may bring our illustration closer to reality by multiplying instances. It must be understood that not only the Remington Typewriter Company, but thousands of other American exporters, are selling to the American bank claims upon English importers. The bank, by sending the purchased drafts to its correspondent bank in London, builds up in the London organization a large balance which is held subject to the order of the American bank. But, also, the American bank is constantly selling banker's bills (such as that purchased by Gimbel Brothers) which before long are presented for payment at the correspondent bank; and these payments bring about a steady reduction in the balance that is being built up in the manner described above. It must be remembered, of course, that there are many banks dealing in foreign exchange, and many correspondent banks in foreign countries, instead of only the one of each that enters into our example.

In the payments described above, the American concerns took the initiative in both instances; that is to say, the Remington Typewriter Company "drew" on the London and North Eastern Railway, and Gimbel Brothers bought a bill of exchange with which to pay their indebtedness to the Wedgwood Pottery Company. It should be obvious, however, that the British companies might have made the first move, the Wedgwood Pottery Company selling to the London bank a draft on Gimbel Brothers, and the London and North Eastern Railway purchasing from this bank a banker's bill of exchange with which to remit to the Remington Typewriter Company. There is no universal practice in the matter; in some instances the exporter will "draw" and in other cases the importer will take the initiative and settle the account by forwarding a bill of exchange. Whether one method or the other is employed depends upon the terms of the business transaction between exporter and importer.

It would be possible, of course, for importers always to meet their obligations through the purchase of banker's bills, thus obviating the use of commercial bills such as that employed in the transaction between the Remington Typewriter Company and the London and North Eastern Railway. The effect is the same whichever method is adopted. In every instance importers pay funds into banks of their respective countries, and exporters draw funds from banks, the latter by selling claims upon foreign concerns and the former by buying claims. If, then, the value of all goods exported from the United States to England is exactly equal to the value of goods imported from that country to the United States, American importers will pay into American banks handling foreign exchange, precisely the amount which American exporters will draw out. Likewise, the payments of English importers to British dealers in exchange will equal the withdrawals by English exporters. Under these

conditions, all payments necessitated by reason of foreign trade may easily be made without shipment of gold.

"Triangular Exchange."—The settlement of international indebtedness is often a much more complicated matter than is suggested by the simple processes that we have described. We have referred, for example, to the fact that a country's imports are paid for, in the main, by its exports. But in the case of two countries, the one may export to the second considerably more goods than it imports from that country. It would seem, in a case of this kind, that a great deal of gold would have to be transferred in order to make up the balance; and, of course, transfers of gold do take place. There are ways, however, to avoid the actual shipment of gold in many instances. An example of "triangular," or "three-cornered," exchange will illustrate this point.

There are some countries from which the United States imports a large quantity of goods, but to which it sends but few goods in return. We have already seen that in normal times we buy great quantities of silk from Japan, coffee from Brazil and Colombia, and rubber from the Malay Peninsula. In instances such as these (and especially when the import consists of raw materials from a rather primitive country), our imports from individual countries exceed our exports to these countries. On the other hand, we export to certain countries (as, for example, to England) more than we import from these specific countries. If we add to these facts the assumption that England exports to one of these countries (say, to Colombia) more than she imports, we have conditions such as form the basis of triangular exchange and make it possible to effect settlements without the use of gold.

Since American imports from Colombia materially exceed our exports to that country, while our exports to England are greater than our imports, there should be available in New York an abundance of London exchange, but little or no opportunity there to buy bills of exchange payable in Colombia. How, then, shall American importers settle their accounts in Colombia? And how shall English importers pay bills due manufacturers and merchants in the United States for shipments from America to England? The problem is solved by American importers purchasing, in New York, London exchange which can be used for the settlement of debts in Colombia. For London is a world clearing house for foreign exchange, and exchange drawn on a London bank is acceptable in virtually any part of the world. This London exchange originates through American exporters drawing on English importers and then selling these drafts to New York dealers in exchange. Therefore, American importers can pay for goods imported from Colombia by sending to Colombian business men the London bills that they have bought in New York.

The bills can then be sold by these Colombian exporters to other per-

sons in their country, who in turn have imported goods from England and are anxious to have drafts on London with which to meet their obligations. When the Colombian importers have settled their accounts with English exporters in this way, the exporters present the drafts for collection to the English importers of American goods (upon whom they were originally drawn), and when they are paid all obligations have been met. The several steps in the process are illustrated in Fig. 56, in

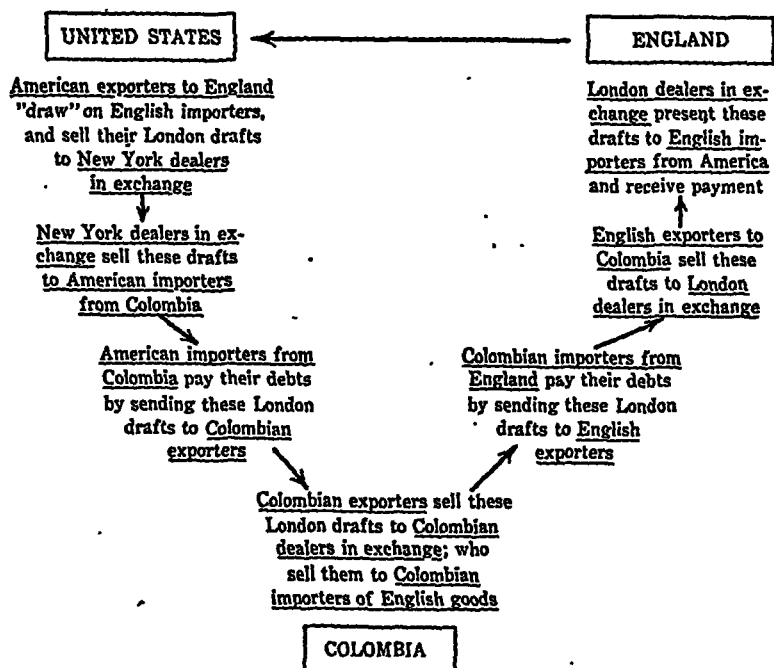


FIG. 56.—AN EXAMPLE OF "TRIANGULAR EXCHANGE"

which the arrows indicate the direction in which the drafts move, the goods moving, of course, in the opposite direction.

The Rate of Exchange.—Naturally, the bankers handling foreign exchange make a charge for the accommodation; but this charge is paid willingly enough, since the use of foreign exchange makes it unnecessary to send gold overseas in settlement of indebtedness. The monetary unit of the United States is the dollar, and of England the pound sterling. Americans, of course, wish to be paid in either dollars or gold, and Englishmen in either pounds or gold. There is no difficulty about this, however, since the English exporter is in reality paid by the London bank in money which this bank has received from English importers. It is therefore British money, or pounds sterling. A similar situation exists in the United States, for American exporters receive from their banks American dollars that have been paid in by American importers who require

banker's bills with which to settle foreign obligations. This is true so long as exports and imports between two countries are equal.

There are times, however, when exports from the United States to England are either greater or less than imports from England. Let us suppose, for the moment, that they are greater. This means that American exporters are drawing from American banks more than American importers are paying in. In England, the situation is reversed; British importers, through their purchase of bills of exchange with which to pay obligations in America, are paying into English banks more than British exporters are drawing out, for British imports are greater than exports. If American exports exceed imports to a considerable extent, the quantity of London exchange for sale in New York (that is, bills of exchange payable in London in pounds sterling) increases, while at the same time (because of the relatively small imports) there is little call for these bills on the part of American importers.

Changes in Exchange Rates.—Applying here the laws of price determination, which we have already explained in detail, we see that, because of the large quantity of London exchange offered for sale and the small quantity desired, the price must be low. London exchange in New York is said, under these circumstances, to be “at a discount,” that is, it will sell below par. Moving quickly to England and viewing the situation from that angle, we find that there are many British importers anxious to buy New York exchange with which to pay American exporters. But New York exchange is scarce in London because there has been little exporting to the United States. As a consequence, New York exchange in London will sell “at a premium,” or above par.

We can find the *par of exchange* by comparing the gold content of, say, the dollar and the pound sterling. A British pound sterling commands \$4.8665 in gold when it contains (as in 1931) 4.8665 times as much pure gold as the dollar. When exports and imports are at a par (that is, exactly equal in value) the *rate of exchange* between dollars and pounds will also be at par, and the American importer can purchase bills of exchange payable in London in pounds sterling, on the basis of \$4.8665 per pound, plus the dealer's commission.

But if exports from the United States to England are greater than imports, he will be able to buy London exchange at less than par, perhaps at \$4.85 per pound sterling. At this same instant, the British importer in London, seeking to purchase foreign exchange payable in New York in dollars, will discover that he must pay more than par for a bill of exchange, that is, for each pound sterling he will receive only \$4.85 worth of American dollars.

It should now be clear that an excess of American imports over exports will reverse the situation, and London exchange will, in New York, sell

at a premium (say, at \$4.88 per pound), while New York exchange in London will sell at a discount; that is, a pound sterling will buy more than a normal amount of dollar purchasing power—\$4.88 worth, to be exact. The problem, then, is one of supply and demand. The price of foreign exchange is low when there is an abundance of it available, and the price is high when bills of exchange are relatively scarce.

"Gold Shipping Points."—There are, however, heights and depths beyond which the price will not go. These are known as the "gold shipping points," and they represent deviations from par beyond which it will pay the importer to ship gold in payment of his foreign obligations. If the shipping costs of a pound sterling between New York and London (covering transportation, insurance, and all handling charges) are, say, two cents, then the American importer will refuse to buy London exchange if the price goes above \$4.8865, since it would be cheaper to ship gold than to pay a higher price for bills of exchange. Similarly, American exporters, in selling to American bankers their claims upon British importers, will not take less than \$4.8465 per pound sterling, for it would be more profitable to have gold shipped from England in settlement of their claims than to sell the claims at a figure smaller than the amount mentioned. When there are no obstacles to the free movement of gold, the rate of exchange is ordinarily held between these upper and lower gold shipping points. In actual practice, gold shipments are made not by importers who have obligations to meet, but by bankers who thus increase their balances abroad and then sell foreign drafts against these balances. However, the fact that importers *could* pay their bills by shipping gold prevents the rate of exchange from going beyond the gold shipping point.

PURCHASING-POWER PARITY

Thus far, we have been considering foreign exchange between countries that are on the gold standard. But nearly all of the countries that play important rôles in international trade have abandoned the gold standard, and there is no longer a free movement of gold between them. If two countries, one on a gold and the other on a paper standard, engage in trade, the exchange rates will no longer be anchored to the gold parity and may deviate widely from such parity. This is true because the departure from the gold standard eliminates the possibility of free gold movements. The statement holds also for trade between two countries both of which have departed from the gold standard. Because the exchange rates lose their connection with a gold parity, it does not follow that there is no parity, or "norm," about which the actual exchange rates will tend to fluctuate. Indeed, there is such a norm, which we call "purchasing-power parity," and which means that the parity of exchange is

based upon the purchasing power, and not upon the gold content, of money.

Purchasing-power parity therefore is a ratio which expresses the relationship between the price levels of the two countries under consideration. It must be thought of as an *ideal* ratio, just as the gold parity of $\text{£}1 = \$4.87$ is an ideal ratio. But just as the *actual* rates of exchange frequently vary from the ideal when both countries are on the gold standard, so also may actual rates of exchange vary from purchasing-power parity when the trading countries have left the gold standard. As these lines are written, the pound is quoted at \$4.00. This is, of course, the *rate of exchange* at this particular time, and not necessarily the *par of exchange*.

Purchasing-power Parity and Domestic Price Levels.—When both England and the United States were still on the gold standard and the gold parity of $\text{£}1 = \$4.87$ was in actual force, this expression of the parity of exchange could be taken literally. *For £1 was a given quantity of gold, and \$4.87 was precisely the same quantity of gold.* When international trade was transacted upon this basis of exchange, what happened was that a quantity of economic goods valued in England at approximately 125 grains of gold nine-tenths fine¹ ($\text{£}1$) was sent to the United States in exchange for a quantity of economic goods valued in America at 125 grains of gold (\$4.87). Thus goods exchanged for goods, as they always must in international trade, either immediately or eventually. The ratio at which they exchanged was determined by the relationship between the *purchasing power of gold in England and in the United States*. Under purchasing-power parity, the ratio at which English and American goods exchange is likewise determined by the *relationship between the domestic price levels*—expressed now, however, not in terms of gold but in paper pounds and dollars, respectively. With both England and the United States on a paper monetary basis, the statement that $\text{£}1 = \$4.00$ means that the purchasing power of the paper pound in England is approximately the same as the purchasing power of \$4.00 (paper) in the United States. This exchange rate, then, is based upon the relation between the domestic purchasing powers of the two national currency units.

There is nothing surprising about the parity of exchange being based upon the purchasing power of money in the countries that issue it, for eventually the money must be spent in the countries of issue, if it is to be spent at all. Paper pounds are generally acceptable in England but not in the United States, and paper dollars in the United States but not in England. Hence, pounds must be spent in England and dollars in the United States. It follows that the value of the pound and the dollar must depend, in the final analysis, upon what they will buy in England and

¹ In the interests of strict accuracy, it may be noted that British gold used for monetary purposes is eleven-twelfths fine, while American monetary gold is nine-tenths fine.

the United States, respectively. Let us suppose that these two countries, both being on a paper money basis, engage in international trade, and that all commodities and services purchased by the people of England in the United States are paid for in paper pounds, and that all goods bought by Americans in England are paid for in paper dollars. It is obvious that trade could not stop at this point, since dollars in England and pounds in America lack general acceptability and are therefore but slightly useful. To be used to greatest advantage they must be returned to the country of issue and spent there for economic goods, and their usefulness will be measured by the quantity of goods they command in that country.

Speculation in Foreign Exchange.—It should be noted, further, that speculation may enter into a situation such as we have described. If, for example, it appeared likely that we should soon have a rise in the price level of the United States without a corresponding rise in England, there would be a rush to convert dollars into pounds, in anticipation of the loss of purchasing power that dollars would suffer through an increase in general prices in the United States. This increased demand for pounds would alter the ratio of exchange, which might be expected to move to $\text{£}1 = \$4.25$, or to some other ratio indicating the enhanced value of the pound as compared with dollars. If a decline in the American price level were expected, with no change in general prices in England, we may be sure that Britishers would seek to buy up dollars while they were still relatively cheap. Their bids for dollar exchange would have the effect of raising the price of drafts payable in dollars, with the result that the number of cents obtainable for a pound would begin to move downward from the present 400, and might eventually get as low as (say) 375, when the rate of exchange would be $\text{£}1 = \$3.75$. If, on the other hand, the present *nominal gold parity* of $\text{£}1 = \$8.24$ were expected to come into force, there would be an immediate scramble to buy pounds while they were still available at \$4.00 in American paper money; and this scramble would cause the “\$4.00” of the present paper ratio to move in the direction of the \$8.24 which the pound would cost, once the new gold parity had been adopted.

Speculation takes place also in the foreign exchange of countries which are firmly established on the gold standard and make no effort to prevent the shipment of gold. Dealers in exchange, like dealers in any other commodity, will buy in anticipation of a rise and sell in anticipation of a decline in price. Consequently, there are always some people buying foreign drafts because they expect an increase in demand which will enable them to reap a profit, and others selling because they look for a decline in demand which would render their holdings less valuable than they are at present. However, the exchange rates of paper currencies offer a wider scope for speculative operations than the rates of gold standard

currencies; for the latter, it will be recalled, can vary only between the gold shipping points, whereas the former are likely to fluctuate more widely.

THE BALANCE OF PAYMENTS

"Favorable" and "Unfavorable" Balances of Trade.—We have yet to consider the contention that the exports and imports of a country tend to be equal, and to examine briefly the mechanism which brings about the equilibrium between exports and imports. In this connection, we shall find it convenient to make use of two terms which are met with continually in the literature of international trade. For many decades, economists have been writing about "favorable" and "unfavorable" balances of trade. Indeed, the terms originated at a time when it was considered decidedly advantageous for a nation to send abroad more goods than it imported, so that it might receive gold in payment of the balance. Of more recent years we have come to the realization that the acquisition of a very large quantity of gold is not necessarily a great blessing, but may bring about distinctly unpleasant consequences through its effects upon the credit-currency systems and the price levels of the countries sending and receiving the gold. Consequently, the terms "favorable" and "unfavorable," when used in connection with an international trade balance, are likely to be misunderstood. It would certainly be clearer to refer to an "excess of exports" or an "excess of imports"; but the other expressions have become so firmly fixed in our economic language that there seems to be small hope of ousting them.

The Long-run Equalization of Trade.—To many people, international trade appears to consist primarily of exports and imports of merchandise and services of the types listed in Items 1 to 8 of Table 42. Before the era of large-scale foreign investments, these were, of course, the items of greatest importance; and it was a commonplace among writers on economics that what a country exported in the way of such goods tended to equal its imports of these kinds. Even today, when long-term investments and changes in international banking accounts form an appreciable part of a country's exports and imports, it should be obvious that, although such "claims upon economic goods" may be acceptable temporarily in exchange for economic goods, yet they are acceptable only in the sense that they constitute deferred payments; and sooner or later the holders of these claims will expect to convert them into commodities and services.

If, then, a country—say the United States—maintains a "favorable" trade balance by exporting year by year more economic goods than it imports, and receiving in exchange for its excess of exports such claims upon foreigners as are represented by stocks and bonds, we may be sure that there will come a day of reckoning when the holders of these claims

will call for payment. The direction of trade will then have to be reversed, for payment must eventually be made, if it is made at all, in economic goods. Moreover, payment will involve an *excess* of imports over exports, and the United States will then have a so-called "unfavorable" balance of trade. This is but one more illustration of the fact that trade consists, at least in the long run, of an exchange of commodities and services for commodities and services.

Maintenance of Goods Balance Under the Gold Standard.—The length of time required to balance exports and imports of economic goods cannot, of course, be predicted with anything approaching accuracy, but we may inquire into the method of bringing about this equilibrium. Let us suppose, for the sake of simplicity in explanation, that all international trade consists of economic goods, neglecting for the moment such items as long-term investments and changes in international banking accounts. Let us suppose, further, that the countries which engage in trade are all on the gold standard.

It is safe to say that people ordinarily buy in their own communities, and certainly in their own countries, unless there is an advantage to be had through purchasing in a more distant region. If, for example, Englishmen import goods from the United States, they do so because they can buy here to greater advantage than at home. This would mean, in all probability, that certain commodities and services were obtainable at lower prices in the United States than in England. Otherwise there would be no incentive to buy at so great a distance. Therefore, if American exports of economic goods should continuously be greater than imports, we should expect to find the cause in the lower prices that prevail in the United States for the goods desired by foreigners, and the high prices in other countries for goods which might be purchased by Americans except for the fact that they can secure them at lower figures right at home. But if the United States continued for a long time to have larger exports than imports, the balances year by year would be paid in gold; and this gold might be expected to increase the quantity of circulating media in the United States and thus raise the price level.

An increase in general prices would eventually make itself felt in international trade. For not only goods that are sold at home, but those entering into international trade as well, would advance in price; and, in the course of years, these goods would be offered only at figures which were prohibitive, so far as foreign purchasers were concerned. For just as the influx of gold to the United States would raise prices, so also its flow from other countries would lower price levels in those particular countries; and thus it would become increasingly difficult for American business men to quote prices which would induce foreigners to buy in the United States instead of at home. Indeed, we might expect prices in foreign countries to decline so greatly that American purchasers would

be attracted, and as a consequence American imports for a time might exceed American exports. We have, then, in the movement of gold a device which tends to bring about an equilibrium between exports and imports of commodities and services. If the balance is upset to a very considerable extent, so that the rate of exchange comes close to the gold shipping point, a movement of gold takes place which in time may be counted upon to restore the equilibrium once more.

Equilibrium of All Payments Under the Gold Standard.—Having seen how exports and imports are balanced under the relatively simple conditions which we assumed to exist, we may now introduce the capital movements which are included in Table 42 under Items 9, 10, 11, and 12. Paper currency movements, listed as Item 15, are similar in character to these several capital items, since paper money is in reality a credit instrument. Item 16 consists of a host of things which, if we knew perfectly all details of the situation, could be distributed elsewhere in the table; and silver (Item 14) may be regarded as merchandise. Thus we can include among exports and imports every item in Table 42, with the single exception of gold; and gold, it should be observed, is customarily regarded purely as a means of settling balances in international trade, when the nations engaging in trade are on the gold standard, as they are under our assumed conditions. If, then, our international balance sheet were the one appearing as Table 42, we should find that (apart from gold shipped) the exports of *all items* (or credits) amounted to \$8,779,000,000, and the imports of *all items* (or debits), to \$4,035,000,000, requiring a net gold import of \$4,744,000,000 to bring the two into equilibrium. The gold transferred in 1940 represents, as we have explained, a far larger percentage of the total volume of transactions than in normal years.

Obstacles to the Automatic Attainment of Equilibrium.—This shipment of gold, like the shipment mentioned in an earlier paragraph, might be expected to raise somewhat the price level of the country receiving it—the United States—and to depress somewhat the price levels of the countries losing it, thus tending to bring about a readjustment of trade which would bring exports and imports into balance. However, we cannot be certain that gold entering a country may not be “sterilized” (that is, kept by the central banking system from forming the basis of credit expansion), and thus be prevented from raising the price level. And it is also possible that the country losing gold may liberalize its policy of credit extension so as to keep the loss of gold from depressing its level of general prices. In the face of such credit manipulation, the readjustment to which we have referred might not take place promptly. However, it would not be possible to continue the shipment of gold in one direction indefinitely, without forcing off the gold standard the country whose stock of gold was being depleted. And once it had abandoned the gold standard, the value of its paper currency would soon fall and the di-

rection of trade would be reversed. This statement does not apply to *gold-producing countries* which mine and refine year by year a sufficient quantity of gold to enable them to meet unfavorable trade balances in gold without drawing upon the stocks of bullion needed for the support of their monetary and banking systems.

The Influence of Changes in Rates of Exchange.—At this point we must emphasize the fact that the forces making for an equilibrium of exports and imports are at work all the time, and do not become active merely when the rate of exchange has reached the gold shipping point. It will be remembered that international payments are usually made through the medium of bills of exchange, and that a favorable balance of trade for the United States requires the people of other countries who are importing American goods to pay a premium when they buy dollar exchange, since the demand is great and the quantity available is relatively small. At this same time, and for the same reason, foreign drafts will sell at a discount in New York. For example, the discrepancy between exports and imports might be so great that dollar exchange would sell in London at as high a price as £1 = \$4.85. This high price charged for the means of making payments for American goods would in itself have a depressing effect upon exports from the United States to England, and the low price of sterling exchange in New York would stimulate imports from England to this country. It is evident, then, that fluctuations in the rate of foreign exchange tend to bring trade balances into equilibrium, and that the shipment of gold in settlement of balances takes place only after the rate of exchange has moved so far from gold parity as to reach the gold shipping point.

The Handling of Gold Shipments.—It will be well also to explain more fully the statement, already made, that movements of gold, when they occur, are not handled by the importers of goods. This service is ordinarily performed not by the importers of goods, but by dealers in foreign exchange who, when the gold shipping point is reached, make a shipment of gold themselves and thus build up foreign balances against which they may write foreign drafts and sell them to those who must pay bills in foreign countries. On such drafts the dealers in exchange will naturally charge a premium which will reimburse them fully for the cost of shipping the gold, and yet will not make the total cost to the buyer higher than the cost which would be entailed if he undertook to pay his foreign obligations by shipping gold himself. Furthermore, if there is a probability that gold will soon move in the opposite direction, the additions to foreign balances referred to above may be made through a credit transaction instead of a gold shipment, since it would obviously be silly to send gold to England only to have it promptly returned. Credit transactions of this kind appear in the international balance sheet as changes in international banking accounts (Item 10 in Table 42).

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Maintenance of the Trade Balance Under Purchasing-power Parity.—When countries engaging in international trade are not on the gold standard, any shipment of gold which takes place is regarded as a merchandise transaction and not as a means of balancing exports and imports. Under purchasing-power parity, the balance of payments is maintained wholly through fluctuations in the rate of exchange. But whereas, under a gold standard, the fluctuations cannot go beyond the gold shipping points but give way at these points to the shipment of gold as a force making for equilibrium, under purchasing-power parity they know no definite limits and will extend as far as may be necessary to effect a balance between total exports and total imports. If we assume, for example, that with England and the United States on a paper monetary basis the *normal* rate of exchange (that is, the *par of exchange*) is £1 = \$4.00, we can readily see that a favorable balance of trade for the United States would, as in our gold standard illustration given above, place a premium upon dollar exchange in England. This premium, as we have explained, would tend to turn the tide of trade; if it did not succeed in so doing, a still higher premium would be charged, and the price of dollar exchange would continue to rise until exports from the United States were sufficiently discouraged and imports to the United States were correspondingly encouraged. There can be no question that a long-continued rise in the price of dollar exchange, and a consequent decline in sterling and other foreign exchange, would finally bring about an equilibrium between exports and imports.

The *par of exchange* (gold parity) of the currencies of two countries, both of which are on the gold standard, is the ratio of the *gold contents* of these two currencies, expressed in monetary terms.

The *par of exchange* (purchasing-power parity) of the currencies of two countries which are not on a common metallic monetary standard, is the ratio of the *purchasing powers* of these two currencies in their respective countries of issue.

The *rate of exchange* of the currencies of two countries is the *actual market price* of each currency in terms of the other.

1. Why is gold generally acceptable in international trade transactions, whereas paper money is not?
2. To what extent was gold used in the settlement of international payments in 1940 (Table 42)?
3. Why do we wish to avoid the use of gold in making international payments?
4. What device used in our modern "clearing houses" is utilized for reducing materially the necessity of shipping gold for the settlement of international obligations?

CHAPTER 40

OBSTACLES TO INTERNATIONAL TRADE



IN CHAPTER 38 we looked into the nature of international trade and saw that it consists, in its essence, of an exchange of the commodities and services of the people of one country for the commodities and services of the people of other countries. The purpose of the individual exporter, in sending goods to foreign lands, may be to sell these goods for money. But, from the point of view of the nation as a whole, the purpose of exporting is to make it possible to import.

If, as should now be clear, the object of engaging in international trade is to obtain goods which can scarcely be produced at home, or can be produced abroad more advantageously than at home, how may a nation gain most from its trade with other nations? Will it be by sending to other countries as many commodities and services as possible, while receiving few in return? Will it be, in other words, by giving every possible encouragement to exportation while seeking, by artificial means, to keep imports at the lowest possible ebb? Obviously not. We should seek, as a nation, to get as many commodities and services as possible from other countries, while giving to other countries as few as possible. From the point of view of the nation, then, *we gain from international trade through importing*. And those who regard international trade as an opportunity to sell goods for money may be reminded that our ability to export is limited by our willingness to import, since the imports of a country as a whole must, in the long run, equal its exports.

The Case for Free Trade.—The case for free trade is the case for the world-wide geographical specialization of labor. If every country specialized in those lines of production in which its effectiveness is greatest, the resources of the world as a whole would be used in the most productive way. The result would be the production of the greatest possible total of all commodities and services. When these economic goods were distributed on the basis of free trade, each nation would obtain a greater sum total of enjoyable goods than would be available through any other process.

The Prevalence of Restrictive Trade Policies.—While we should not rate highly the intelligence of an individual who tried to gain economically by giving away as much economic goods as possible in return for as little as

possible, many nations have tried to gain by the adoption of a similar policy. That is, in spite of the weighty arguments for freedom of trade, most nations have adopted policies which greatly restrict the international exchange of goods. Various devices enter into the prosecution of such policies. Since the protective tariff has been the most important barrier to international trade in the past, we shall discuss it in some detail before turning to an examination of more modern restrictive devices, such as import quotas and foreign exchange controls.

Under a protective tariff, certain goods produced abroad are made dutiable at rates designed to exclude these products, thus leaving the home market free for exploitation by domestic producers turning out the same kinds of goods. If, for example, a certain grade of cloth can be obtained from England for 25 cents a yard but cannot be produced in this country for less than 35 cents, then a duty of, say, 15 cents a yard is levied upon this grade of cloth, so that our wants will be satisfied by domestic manufacture, if satisfied at all. When similar duties of varying amounts are applied to hundreds or thousands of articles, the result is a "protective tariff." Many rates are more than sufficient to exclude the foreign products, while others are, in effect, low enough so that imports continue to come in to some extent despite the duties. But the purpose of the protective tariff is clearly the exclusion of foreign goods.

Particularly since the first World War has it been true that large numbers of nations, whether or not they were formerly worshipers at the shrine of protection, have adopted tariffs and other protective devices. Moreover, practically all changes in tariffs until quite recent years have consisted of upward, rather than downward, revisions. The question under consideration is whether it is wise for individual nations, and for the nations of the world collectively, to maintain obstructions to trade. If tariffs and other protective devices are beneficial, it is highly desirable to discover how the disadvantages often associated with them may be reduced. And if in general they are detrimental, we should consider what steps may be taken to bring about their removal, or at least to revise them in a downward direction.

Protection as a World Policy.—Since territorial division of labor and freedom of trade would bring the greatest sum total of enjoyable commodities and services to the world as a whole, it is true that protective measures are a tremendous source of economic loss when considered from this point of view. They cause the resources of the various nations of the world to be used, in many instances, in lines of production to which they are ill adapted, and the gains which would result from the application of the principle of geographical division of labor are thus lost. The result is a much smaller total amount of goods for the world as a whole than the maximum which could be obtained. But the people of different nations do not often or seriously consider world advantages or disadvan-

tages. Personal or local advantages are usually the prime considerations of immediate importance, while national advantage is thought to be the ultimate goal to be attained.

THE PROTECTIVE TARIFF AS A NATIONAL POLICY

We now turn to an examination of the protective tariff as a policy for a single nation such, for example, as the United States. The controversy over the tariff has raged loud and long in this country. The arguments advanced in connection with it have run the gamut from abysmal ignorance and childish superstition to intelligent and clear-cut reasoning. There are Americans who are today no more advanced in their thinking on international trade than were many statesmen of the sixteenth and seventeenth centuries, and who believe that a protective tariff is a good thing because, by cutting down our imports, it enables us more easily to maintain a favorable balance of trade. Thus, they still hold to the ancient belief that a country, like an individual, may become rich by selling more than it buys. The meaninglessness of the central idea of this belief—the idea of a favorable balance of trade—was commented upon in the preceding chapter.

The Tariff as a Revenue Producer.—Others believe that a protective tariff should be maintained, without too much regard for its indirect effects, because the government could ill afford to do without the revenue which is produced by it. Such an argument mistakes the main purpose of a protective tariff, which is to exclude foreign goods from the domestic market. A perfectly effective protective tariff would not furnish a single penny of revenue to the government, because no goods would come in to pay the duties imposed. Only to the extent to which a protective tariff falls short of its prime objectives does it add to our national revenues.

The Tariff and Industrial Progress.—Probably the most objectionable and completely fallacious argument for the protective tariff is that which often appears in newspaper editorials and in the speeches of politicians, to the effect that all the prosperity of the United States, past and present, is to be attributed to the policy of protection. When the protective tariff was first applied in this country, we were largely an agricultural nation, dependent upon European countries for most manufactured products. This, it is held, we would have remained if we had not adopted a protective tariff. Consequently, runs the argument, the credit for our progress in manufacturing and our industrial development should be given to the tariff.

No one will deny that the industrial development of this country was hastened to some extent by our policy of protection. So many duties applied indiscriminately must certainly have afforded a stimulus for some industries. On the other hand, there is no doubt that our development

has in other ways been retarded by the protective tariff. The principal objection to the argument is, however, that it disregards the tremendous natural resources of the United States and our growing population—in short, the presence in abundance of all the conditions which could not have failed to bring about the development of the United States into a great industrial nation under any international trade policy which might have been adopted. If the tariff alone were enough to cause prosperity and industrial development, there would be no excuse for any nation being poor and backward, because the application of the protective policy is relatively simple.

The Protection of "Infant Industries."—One of the earliest and strongest arguments for the protective tariff has to do with the encouragement of young industries. In so far as other countries have advantages over us in production which rest upon natural conditions, there is little that can be done about it. But, in the early days of a country, many advantages in production possessed by other countries are of the acquired sort; that is, the foreign industries are temporarily more productive because of the advantage of an early start and years of practice in these lines of production. To accept this condition as natural and permanent, and to buy the products of these industries from foreign countries continually, may be to disregard the young nation's best interests. For it may well be that, if the young and temporarily inefficient industries are protected from foreign competition for a time, they will develop in size and efficiency until their products can be turned out more advantageously than those of other countries. Clearly, a nation should produce goods at home whenever it is more advantageous to do so than to obtain them from other countries, and it is anticipated in the case of infant industries that the gains to be realized after the industries have grown up will be more than sufficient to compensate for the losses sustained while protection is necessary.

This argument is, therefore, valid to some extent, but its validity is weakened by two circumstances. In the first place, it is impossible to decide with accuracy in advance just which industries will eventually become strong and self-sustaining. The policy of the United States has been to grant protection whenever it was asked, and it is certain that some of the industries protected must have been greatly stimulated by our tariff. On the other hand, it is equally certain that some industries have been kept alive up to the present which should have been permitted to die a peaceful and natural death a hundred years ago. Such industries have always been dependent upon the tariff for their existence, and in all probability always will be. The second circumstance is that industries, however great and efficient they may become, never feel that they are sufficiently grown up to give up tariff protection and face foreign competition. The steel industry in the United States, for example, would be considered by most persons a particularly lusty infant, and yet it has not

insisted that it be allowed to make its way in the world without protection. Whatever may have been the validity of the infant industry argument in the past, it is certain that for the future it must carry very little weight.

The Home Market Argument.—Ignorance or disregard of the basic principles of international trade enables protectionists to advance what is called the "home market argument." It is contended that the exclusion of foreign products from the country will leave the home market entirely to domestic producers, thus giving them a new market in addition to that which they already enjoy. Production and employment will be stimulated, it is said, and wage conditions improved. But it is a fundamental principle of international trade that the exports of a country must equal the imports in value over a period of time, and that if a country will not import, it cannot continue to export. To the extent that the protective tariff shuts out imports, our exports must eventually suffer, and the home market is built up only at the expense of the foreign market. The home market may be slightly the more desirable of the two, or it may be less desirable. The question is not one to be decided in an off-hand manner. In any case, however, no large additional market can be created by the tariff.

Wages and the Tariff.—The most effective argument for protection, from the point of view of obtaining from the people of this country a sufficient number of votes to authorize the continuance of the policy, has to do with the effect of protection on wages. At times it has been held that the protective tariff is the cause of high wages. Does not the tariff permit the protected enterprisers to charge higher prices than they could otherwise charge, and do not the higher prices lead to higher wages for the workers? This line of reasoning puts the cart before the horse. According to the theory of opportunity costs, which was explained in Chapter 14, enterprisers in protected industries have to pay, for units of the factors of production, prices which are as high as these factors can command in other industries. The combination of the factors of production in the industries requiring protection, however, is for some reason not so effective as in other industries, so that the products of the former cannot be turned out at prices which will admit of effective competition with similar foreign-made products. As a result, these industries need a tariff because it will permit them to charge higher prices than could be obtained in competition with the industries of other countries, and it will enable them to continue producing while paying the current prices for the factors of production. Since the market rate for labor is more than could be afforded in these industries if the tariff were not in effect, it is true in a sense that the protective tariff has the effect of bolstering up wages in these particular fields of business.

There is, however, no reason to suppose that higher wages will be

paid for labor of a given grade in protected industries than elsewhere, or that wages in general will be raised by the tariff. The relatively high level of wages in this country depends upon the relatively high effectiveness, or productivity, of labor. Wherever the productivity of labor is high, wages tend to be high, regardless of the policy used in international trade. The United States glories in the possession of a comparatively high level of both money wages and real wages under a protective system, and yet England is ordinarily second only to us in both respects under a system which until recently has been practically free trade. It would be most heartless of us to allow any of our people to live in misery and want because of insufficient earnings, if their condition could be improved by the simple expedient of enacting a higher protective tariff. That it could not be so improved reduces the high-wage argument to an absurdity. Our conclusion, then, must be that the most probable effect of the tariff on wages is to reduce real wages by causing the prices of many commodities to be higher than they would be without the tariff.

Protecting the American Standard of Living.—Many people in this country believe firmly that, while high wages are not caused by the protective tariff, the maintenance of a high level of wages and a good standard of living depends upon the tariff. The argument runs along these lines. The wages and the standard of living of workers in this country are high, and we take pride in the fact. But our enterprisers, because they pay high wages to these workers, necessarily have high costs of production and are rendered unable to compete under conditions of free trade with the enterprisers of other countries, who can secure their workers for much lower wages. Under the protective tariff, the cheap goods made by foreign "pauper laborers" are shut out, and our wages and standard of living can be maintained. If the barrier were once let down and a flood of cheap goods came into this country, our own enterprisers would be compelled to shut down and throw men out of work, or else keep their plants running by reducing wages to a point which would make the maintenance of the American standard of living impossible.

The flaw in this argument lies, of course, in the statement that high wages necessarily mean high costs of production. This statement seems unquestionably true to most persons who receive wages and to many others, and yet it is not necessarily true at all. No accurate estimate of labor cost can be made unless two facts are known: (1) the rate of wages paid, and (2) the amount of work turned out for the wages. High wages and large productivity of labor may very well mean low labor cost, while low wages and very low productivity of labor often result in a high labor cost. The truth of this statement can be established by reference to facts which are familiar to all. Money wages in the United States are the highest in the world. If high wages necessarily mean high costs of production, how does it happen that we can sell commodities to the value of

billions of dollars a year (\$4,021,000,000 worth in 1940) to the people of foreign countries? Why, with their low wage rates, can they not undersell us in everything? The answer is that our workers turn out so much product per unit of wages that costs are in reality low, not high, in these lines of production.

Does a country with a high wage level and standard of living have anything to fear from free trade with a country having a low wage level and standard of living? We think not. England with high wages rates and standard of living engaged in trade for many years on a basis of free trade with China, where these labor conditions are exactly reversed, but there was no noticeable tendency to drag English laborers down to Chinese wages and standard of living, or to raise Chinese laborers to the English level. It is important, then, to remember from this discussion that high wages and satisfactory living standards are dependent upon high effectiveness or productivity of labor, rather than upon the maintenance of a protective tariff.

The Tariff and Employment.—The contention that the protective tariff increases employment is related to the high-wage and home market arguments. If we shut out foreign products, it will be necessary to produce our supplies of these goods in this country, and we shall have more industries than otherwise. These industries cannot run without laborers and there will be much additional employment created for our working men. This argument, of course, disregards the familiar fact that if we will not import, we cannot continue to export. As men are put to work producing the goods which are no longer purchased abroad, other men are thrown out of employment in industries producing for the export market. The effect of the whole process is to shift large amounts of capital, labor, and land to the production of goods which could be obtained more advantageously from abroad, instead of using these factors in our export industries where they are especially productive. No large, additional source of employment is created by the tariff. We do, by erecting tariff barriers, make it more difficult for us to obtain the goods we desire, but that is a doubtful advantage. We could also "increase employment"—that is, provide more hours of work—if we impeded production by equipping our workers with ball-and-chain or handcuffs, but apparently our protectionists have overlooked the possibilities of this procedure.

The Protection of Vested Interests.—It is sometimes thought necessary to continue the policy of protection, once it is begun, even though some other policy would be more desirable if we were to begin over again. The reason given is that, under the guaranty of the tariff that foreign competition will be excluded, individuals have made large investments in protected industries and workers have adapted themselves to conditions in these lines of production. If protection is not continued, all of these individuals will suffer losses. It will be seen, however, that this is

not an argument for the protective tariff, but, rather, one against the abrupt removal of protection. Economists generally would concede that the reductions in protection should come gradually, rather than suddenly, but they hold that in any event reductions must be made.

The Tariff as an Instrument of National Preparedness.—When no other argument prevails, protectionists of the old school fall back upon the necessity for national preparedness. Under a system of free trade, the United States would be largely dependent upon other nations for certain commodities, and would be subject to the ever-present danger of having her supplies of these products cut off in time of war. Let us, then, maintain the protective tariff, and thus insure within this country the production of as many essential products as possible, say these protectionists. What if this policy does mean that, to a certain extent, our productive resources will be used ineffectively, and a smaller sum total of commodities and services than the maximum will be produced, just so long as our national security is promoted? This argument, of course, admits the direct uneconomic effects of protection and, in addition, falls short of the mark in another respect. To try to become a self-sufficing nation is to follow a narrow nationalistic policy, and the instrument of this policy, the tariff, is a very prolific source of international ill feeling and friction. Though it may be admitted that it would be a serious matter if our supplies of important commodities were cut off in time of war, we may go still further and recognize the fact that when nations cooperate with and are dependent upon one another on the basis of freedom of trade, the likelihood of war is lessened to a marked degree.

Protection Against Dumping.—In recent years the protective tariff has come to be supported on grounds which appear to be quite different from those which are described above. The tariff is now advocated, for example, as a protection against the dumping of foreign goods in this country. "Dumping" is the term used when the practice is carried on by the people of other nations. When we ourselves engage in such practices, we regard them merely as good business. Dumping has been variously defined, but one useful definition describes it as the sale of goods at a lower price in one market than in another. If, for example, a French perfume sells at the equivalent of twenty dollars an ounce in France, and is marketed in the United States by its producer for ten dollars an ounce, dumping is taking place. Dumping is not a new source of worry for Americans. Indeed, our first tariff to contain any considerable element of protection was passed shortly after the War of 1812, largely because of the expressed determination of British producers to sell goods in this country for any price they would bring, or even to give them away if need be, in order to stifle the young industries which had sprung up in America and thus recapture our market for themselves.

The consideration of dumping gives us an interesting sidelight on the

attitude of Americans toward foreign products. If the foreign products are offered at higher prices than those at which identical products could be turned out in this country, we are often inclined to purchase the articles from abroad as being of superior quality, or for some other reason. To offer us goods at the same prices for which they could be produced here is considered reprehensible, and our suspicions are at once aroused. If foreign producers plumb the depths of infamy by offering to furnish us certain products more cheaply than we could produce them ourselves, we begin to look for the "pauper laborer" in the woodpile and enact a tariff to protect ourselves from this threat to our economic welfare. Finally, to include the worst possible case, if foreigners should offer to give us certain goods free of charge, we would probably go to the extreme of cutting off all trade relations with the offending countries.

Since everyone is presumably interested in getting as many commodities and services as possible at the smallest possible cost, why do we object to the sale of goods to us by the people of foreign countries at very low prices? It is because of the fear that this process will not be continued indefinitely. The sale of goods at these low prices might go on so long that we would become dependent upon others for them and give up their domestic production, only to find the prices raised later above the level at which the goods could be produced in this country. For this reason it is considered well to avoid goods which are offered on suspiciously favorable terms. However, as we shall see later in the chapter, dumping can be guarded against, without continually maintaining high duties which permit the mulcting of domestic consumers.

The Tariff and Economic Stability.—The argument that the protective tariff may be of benefit because it promotes economic stability is close kin to the home market argument. It has been admitted that the tariff may be used to preserve the domestic market for American producers at the cost of reducing our foreign markets to a similar extent, but which market is the more advantageous appears to be a difficult question to settle. The economic stability argument holds that the domestic market is definitely more desirable, because it is more stable. "Let us produce and consume by ourselves to a large extent and shut out disturbing influences. The result may be, of course, that we shall have a smaller sum total of commodities and services to enjoy than otherwise, but may it not be better to have a smaller flow of goods, if the flow is more constant?"

Our answer to this question may well be favorable, as is anticipated by those who advance the argument, but it is at once necessary to ask whether economic stability can actually be obtained by this policy. To what extent is our economic instability the result of importing from and exporting to foreign countries, and thus likely to be affected by the tariff? It is extremely doubtful whether the major factors in the problem of economic instability will be much affected by the tariff policy. Even

though foreign supplies of various products are excluded from the domestic market, it will still be possible, unless domestic production is controlled, for our producers to turn out larger amounts than will be taken by consumers at prices sufficiently high to enable the producers to recover their costs of production. The demand for different goods will not be controlled by a protective tariff and can vary as in the past. Neither can the tariff prevent an overextension of credit in this country. It will consequently appear to most observers that there is room within a country such as the United States for a considerable degree of economic instability, even if outside influences could be shut out.

The Scientific Tariff.—Since the early years of the twentieth century there has been much talk about the true principle of tariff-making, which is that the tariff rates should be just high enough to cover the difference between foreign and domestic costs of production. No favors or special privileges would be granted to domestic producers. Indeed, the tariff would be used only to guarantee a fair contest between foreign and domestic producers, according to its sponsors.

This principle, as it is ordinarily presented, sounds very fair and reasonable, but it will not bear close examination. In the first place, it would be difficult, if not impossible, to ascertain the domestic and foreign costs of production of a wide variety of articles. It is a sufficiently troublesome problem to obtain an approximation of domestic costs, and even greater difficulties are encountered abroad, where information of this sort is considered strictly private and is almost invariably withheld from investigators. Great expenditures would certainly be necessary to secure any worth-while information, and whatever data were obtained would probably be out of date before they could be used as the basis of tariff legislation.

Moreover, even if the principle could be strictly followed, the result would be disheartening. Trade is beneficial because it enables us to obtain goods more cheaply than we could produce them for ourselves. The effect of a tariff in equalizing costs of production would be to remove and destroy all the advantage which exists for us in international trade. Therefore, such trade would be wiped out so far as the United States is concerned. Then, too, let us consider what would happen in this country. All commodities would be protected and all that were consumed by us would be produced here, whatever the cost might be. If the commodity in question were bananas, the procedure would be to find out how much more it would cost to produce them here than in Central America, and then apply a tariff rate sufficiently high to equalize costs of production. The result, so far as most consumers were concerned, would be to raise their price to a prohibitive figure. If the good in question were rubber, silk, or coffee, the same procedure would be followed.

It might be argued that no one would favor carrying the principle to

such extremes, but it is difficult to say just where it would stop. We have records of speeches by United States Senators in which they state that they would be willing to see duties of 300 or 400 per cent applied, if necessary, in order to accomplish the purpose of the tariff. But if we are to go as high as 400, then why not to 800, or to 2000 or 3000 per cent? Moreover, one Senator has favored the draining of the Everglades of Florida so that certain semi-tropical products might be raised there; thus it may be seen that the protection of the commodities mentioned in the preceding paragraph is quite within the range of possibility. All in all, the "true principle" of tariff-making is a ridiculous and worthless one.

Conclusion on the Tariff as a National Policy.—Although the argument, in the present section has been conducted in terms of the United States, as being of greatest interest to American readers, the conclusions which have been reached will apply, changing as conditions change, to other countries as well. The benefits that have been claimed for the protective tariff have been seen to exist largely in the minds of those who find it desirable to support protectionism for some other reason than the reasons they advance. Where benefits have resulted, it is usually true either that they do not continue into the present, or that they could have been obtained more economically by some other method.

The losses under protection are beyond question. The productive resources of each country are diverted from industries in which they would be especially productive to other lines in which their employment is relatively ineffective. The desired commodities and services are obtained under difficulties, and the sum total of goods available for the enjoyment of the people of the country is smaller than otherwise. This ill treatment of all the citizens as consumers results in gains for some enterprisers, but not for others. If the higher prices that can be charged under the protective tariff are just sufficient to enable producers to continue in business in these ineffective industries, then (under conditions of competition) each factor of production will receive payment at the going rate and no more, and the loss to many persons in terms of higher prices will not be compensated by the gains to others. In other cases the tariff will allow prices to be sufficiently high to permit profits, and sometimes very large profits, to the owners of the protected businesses. It is axiomatic, however, that they never gain as much in profits as the people on the whole lose as consumers. In any event, this is taxation or exploitation of the many for the benefit of the few. Whether or not some individuals profit from the use of the protective tariff, it is to be condemned severely on economic grounds.

SUBSIDIES AND INDIRECT PROTECTION

The Use of Subsidies.—Besides the protective tariff, other measures are taken by nations to control the volume and direction of international

trade. Some of the results of a protective tariff can be obtained by using subsidies, which are direct governmental grants to specified industries. When the government pays an industry a given amount on each unit of its output, the industry can sell its product at a price lower than full costs of production. This low price for the domestic product makes it difficult for foreign producers to compete with domestic producers, and relatively easy for the subsidized industry to sell in foreign countries, other things being equal. The price a government pays to maintain a subsidy is readily ascertainable, so that it is clear just which industries are being favored and to what extent. Subsidies have not been an important instrument of trade policy in the United States.

Indirect Protection.—Domestic industries may also be protected by sanitary regulations applied to imported food products, veterinary laws, regulations requiring that imported goods bear a distinctive mark indicating their country of origin, and regulations governing the granting of public contracts, which specify that domestic materials must be used or require materials to come up to certain specifications. All of these measures may have legitimate and non-protective uses, but they may also be designed to discriminate against foreign goods. When the cost of marking a product to indicate the country of origin is greater than its original cost of production, or when the specifications made in public contracts are such that only domestic producers can meet them, these measures may be quite as effective as a tariff in protecting home industries. In the United States, the Pure Food and Drugs Act, the Meat Inspection Act, and the Horticultural Quarantine Act have operated in some cases to furnish such protection.

IMPORT QUOTAS AND EXCHANGE CONTROLS

The Use of Import Quotas.—Import quotas have been used to protect domestic industries chiefly since 1930, and are now employed in more than a score of countries. Their use involves laws or executive decrees which limit (by value, quantity, or weight) the imports of certain articles that may enter the country in a specified period of time. The countries using this device may have both maximum and minimum quotas for individual exporting countries, or they may give special concessions to countries which grant similar concessions in return. The regulations governing import quotas vary widely as between countries in the methods of allocating the quotas among countries which export the specified articles, the time periods in terms of which the quotas are stated, the units in which the quotas are stated, and the base periods on which the quotas rest.

Import quotas may be more effective than tariffs in protecting domestic industries. Normal tariff rates may lose their effectiveness when foreign currencies are being devalued rapidly, when other countries are dump-

ing goods abroad at unusually low prices, when other countries are granting subsidies to their exporting industries, or when there are great disparities among other countries in the cost of production of certain goods. In such cases, a tariff may fail to exclude imports, and import quotas may provide surer protection. A protective tariff, once enacted, is difficult to change, but import quotas are flexible. On the other hand, import quotas, unlike import duties, do not provide revenue, and are more likely than a tariff to disrupt existing international trade relations. Even more important, perhaps, is the fact that import quotas cause goods to move between countries under governmental permit, instead of moving under the influence of price-cost relationships.

Foreign Exchange Controls.—Many countries today control the total volume, specific content, and direction of their international trade. Foreign exchange controls usually operate through a central system for clearing foreign exchange bills. The central bank of the country, or a special agency created for the purpose, is given the power to establish buying and selling rates for bills of exchange, and to deal in foreign exchange. Another agency (perhaps the ministry of commerce or finance) parcels out available supplies of foreign exchange among importers. Exporters of the country are required to demand foreign currencies for goods exported, and to sell their exchange to the central authority which sells it again, to approved importers, at a profit.

Foreign exchange is sometimes allotted on the basis of priority lists, exchange being granted to importers of foods, raw materials, partly processed materials, and finished manufactures on the basis of the importance and desirability of classes of imports as indicated by the priority lists. In addition to such priorities, some goods may be placed on a free list, so that they can be imported at any time, while others may be completely banned and the use of foreign exchange for their importation forbidden at all times. Sometimes foreign exchange is allocated on the basis of the countries from which importers wish to bring goods, so that trade may continue to be divided among countries in the proportions which prevailed before exchange control was established. In certain importing industries, trade associations may be allowed to allot foreign exchange to individual importers, or individual importers may be allowed to share the foreign exchange allotted to a given industry on the basis of relative imports in some past period.

Like the import quotas discussed above, foreign exchange controls are a more flexible instrument of trade policy than protective tariffs. They may be very useful in emergency situations, and their results are more definite and more easily controlled than those of protective tariffs. On the other hand, foreign exchange controls are complicated and expensive to administer, they often lead to favoritism to particular industries or companies, and are particularly likely to divert trade from its natural

channels and upset existing trade relations. Foreign exchange controls are not simply a device for protecting domestic industries. They may be used to stop the movement of gold from a particular country, to stabilize exchange rates, to prevent an outflow of capital, to make sure of obtaining necessary imports, to serve as a bargaining tool in international relations, or for other purposes. Usually, however, they are employed to limit and restrict the volume of international trade, and frequently they give protection to domestic industries.

Blocked Accounts.—Foreign exchange controls may serve to bring current imports and exports into balance, but sometimes a country which imposes such controls may be heavily in debt to other countries and may have to make large annual payments on account of interest and principal. When such a debtor country cannot expand its exports and is unable or unwilling to decrease its imports sufficiently to allow these outgoing payments to be made, its government may direct that the payments be made to banks in the home country but forbid their transfer to the creditor countries. These "blocked accounts" may then be used by their owners for various purposes *within the debtor country*—to pay for travel or study, to make investments in real estate, securities, or business enterprises, or to purchase goods for export. Thus, the blocked accounts are another device for lessening pressure on the international trade, the supply of foreign exchange, and the gold reserves of the country.

Clearing Agreements.—Trading countries sometimes enter into clearing agreements to provide for the settlement of commercial obligations as a whole. A fixed exchange rate between the monies of the two countries is agreed upon, and a governmental agency is set up in each country to handle trade transactions. Importers then pay the domestic authority of their country for goods imported, instead of paying the exporters of the other country, while exporters receive payments from their domestic authority and not from foreign importers. In this way, the obligations arising from trade are settled within each country, and the use of foreign exchange is avoided so long as the total imports and exports of the countries are kept in balance. While clearing agreements are ostensibly used to expedite the payment of foreign obligations, it is obvious that the governments engaging in these agreements are thus enabled to control the volume and content of their international trade, and afford protection to domestic industries. Clearing agreements may also contain provisions for the settlement of outstanding debts between the countries, or separate payment agreements may be drawn up for this purpose.

THE PRESENT AMERICAN ATTITUDE TOWARD FOREIGN TRADE

The protective tariff has been the only device of any great importance used in the United States to control international trade and protect domestic industries against foreign competition. This country has always

been more or less definitely committed to a protective policy, but particularly from the Civil War to 1930 we were the acknowledged leader of protectionism. It is often contended by the supporters of protection that increases in tariff duties have not affected our trade adversely, since they have often been followed by an expansion of trade. This contention is as difficult to disprove as it is to prove, because no one can say definitely how extensive our trade would have been in the absence of a policy of restriction; but there is reason to believe that the tariff has been a decided detriment to us in recent years, in view of our changed economic position.

The United States as a Creditor Nation.—In the middle of the last century, the United States was experiencing an “unfavorable balance of trade,” that is, there was an excess of merchandise imports over exports. This condition arose, in part, from the fact that the country was a borrowing or debtor nation at the time. So long as we continued in that rôle there was little outspoken criticism of our tariff by other countries. People interested in collecting from debtors seldom discriminate against them, or interfere with their chances of becoming prosperous and able to pay their debts. But since the beginning of the last quarter of the nineteenth century our trade balance and credit position have been changing. During and after the first World War our loans to other countries were tremendous, and the United States took a commanding position as a creditor nation.

At the close of 1930, the private investments of the United States in foreign lands were estimated at \$14,900,000,000 to \$15,400,000,000,¹ and the discounted value of the debts of other nations to the government of the United States amounted to \$7,000,000,000. Our loans and investments abroad were not made in the form of money, but consisted of economic goods. If the loans were to be repaid, if our investments abroad were to be retrieved, and if we were to receive income from our loans and investments, the payments had to be made to us not in money, but in commodities and services. If other countries were to pay the United States, say, \$500,000,000 in a given year, it was necessary for their exports to exceed their imports by this amount. By the same token, we could receive such a payment only by allowing our imports to exceed our exports by the same amount.

In the face of a desire to collect our debts and the knowledge that the payments had to be made in the form of commodities and services, we twice raised our tariffs against imports after the first World War and thus made it increasingly difficult for other countries to send us goods. Our Tariff Act of 1922 gave us the highest level of tariff duties in the

¹ United States Department of Commerce, “A New Estimate of American Investments Abroad,” *Trade Information Bulletin No. 767*, Washington, Government Printing Office, 1931, p. 1.

world, except for one other country, and decidedly the highest among the important industrial nations of the world.² The Tariff Act of 1930 was no improvement, for a study of comparative *ad valorem* rates in the two Acts based upon imports for consumption in 1928 showed an increase in the average rate of duty from 33.22 to 40 per cent, in so far as items were comparable in the two Acts.³ This high tariff policy was clearly inconsistent with our position as an outstanding creditor nation.

The Changing Nature of Our Exports.—In the more distant past, foreign countries protested but little against our tariff policy, not only because the United States was a debtor nation, but also because our exports consisted predominantly of raw or semi-manufactured products which these countries greatly desired and against which they would not discriminate. Since the beginning of the last quarter of the nineteenth century, the trend in our exports, as is shown in Chapter 38, has been away from raw and partly finished products toward manufactured goods. These are goods which can be obtained from other countries as well as from the United States, or can be produced in the countries to which we export them at only slight differences in cost in many cases. Consequently, every upward revision of our tariff is now likely to bring in its wake a host of discriminations and retaliations against the United States. Of course, other countries do not ordinarily discriminate openly against our products, or enact tariff laws which are avowedly retaliatory, because our President has been given wide powers in dealing with goods from countries which clearly practice discrimination and retaliation. But it is not difficult to read between the lines of the changing trade policies of other countries.

The Need for Action.—What, if anything, should this country do about its tariff policy in the present situation? In the first place, we should note that the position of the United States as a creditor nation has changed radically since 1930. Prior to that time we were a creditor nation to the gross amount of about \$22,000,000,000. Deducting from this estimate some \$4,000,000,000, as representing roughly our indebtedness to foreign countries in all but short-term obligations, our net creditor position amounted to \$18,000,000,000. In the decade from 1930 to 1939, the war debts due our government from other countries became practically worthless; many factors (including war and the fear of war) drove most of the world's gold supply to the United States; Americans sold a considerable part of their holdings of foreign securities; citizens of other countries invested heavily in the securities of the United States; American

² The League of Nations, Economic and Financial Section, International Economic Conference, *Tariff Level Indices*, Geneva, The League of Nations, 1927, especially p. 16.

³ The United States Tariff Commission, *Comparison of Rates of Duty in the Tariff Act of 1930 and in the Tariff Act of 1922*, Washington, Government Printing Office, 1930, p. 1.

banks, brokers, and others reduced their foreign balances of short-term funds; and foreigners sent large amounts of short-term funds to the United States for safekeeping. As a result, it was estimated (as of September, 1939), that our long-term and short-term investments in foreign countries amounted to only \$11,582,000,000, while the total of long-term and short-term investments of foreign countries in the United States had grown to \$8,830,000,000.⁴ Thus, the net creditor position of the United States was reduced to \$2,752,000,000. It is estimated that in 1940 there was a further net capital movement of \$2,500,000,000 to this country.⁵ Since the obligations of the United States to other countries at present about equal the obligations of other countries to us, this situation is not an important factor in determining our tariff policy.

Because of the present world-wide war situation, the countries which take our exports need them very badly, and our tariff policy will scarcely affect their willingness to buy from us. However, with the restoration of peace our export position is likely to be as vulnerable as before, and the chief issue in our tariff policy will be the extent to which we wish to carry on international trade. It is true that the international trade of the United States is usually only a fraction of the domestic trade of the country. This is not to say that international trade is unimportant, for the ability to sell in foreign markets means, in some industries, the difference between profit and loss. It seems probable that a sharp downward revision in our tariff schedules would lead to similar reductions by other countries, and would result in a considerable growth in the international trade of all these countries. In view of the economic advantages of geographical specialization and exchange, this outcome would be highly desirable.

The Difficulty of Changing the Tariff.—However, it has seemed almost impossible to alter the prevailing sentiment in favor of the protective tariff in the United States. Many millions of our citizens are classed as wage earners, and these workers have been carefully “educated” in the matter of the tariff over a long period of time. That the protective tariff brings with it “high wages and full dinner pails” is to many workers much more than a mere political campaign myth. It is to them a tradition, a religion handed down from one generation to another, and does not appear to be open to argument. The responsibility for the development and maintenance of this belief is easy to place.

The Influence of the Press.—The tariff views of the workers as a class are largely the result of the news items and editorials of newspapers and the speeches of politicians. For many people the newspaper is the one

⁴ A. Maffry and P. D. Dickens, “The Balance of International Payments of the United States,” reprinted from *Survey of Current Business*, February, 1940, Washington, Government Printing Office, 1940.

⁵ *Survey of Current Business*, February, 1941, p. 55.

and only form of literature, and certainly the only available printed medium of information on the tariff problem. Most of the newspapers with which one comes in contact, and particularly those in the great industrial centers where large numbers of workers are found, have been staunch supporters of our tariff policy. To their editorial pages the worker, if his belief in the tariff has been shaken by hard times, may turn with every assurance of seeing repeated the familiar fallacies upon which was built his belief in the benefits of protection. Even in depression, he will find there assurances that the tariff was the foundation of our prosperity in the past and is our only hope for the future. Surely, those who depend upon the editorials of the average newspaper for an understanding of the principles of international trade must always remain in almost complete ignorance of the subject.

The Speeches of Politicians.—The speeches of men in political life, as heard directly or over the radio, or as reproduced in the newspapers, have also greatly influenced popular opinion on the tariff. For many years, both major political parties were in accord in favoring the protective tariff in principle, although they disagreed somewhat about particular schedules. Political talks on the tariff have been almost universally worded in terms of the ancient fallacies with which we are now familiar, and yet they have proved convincing to most wage earners and to many others. The candidate for public office says, "Vote for me. My party stands for the protective tariff, and the tariff is the cause of all your prosperity." People flock to his standard. If the same man said, "Vote for me, because my party stands for the protective tariff, and the tariff is the cause of the heavy rains which have brought you relief from the drought from which you have been suffering," these same people would laugh at him. And yet the tariff would ordinarily be as truly responsible in the one case as in the other.

Students often ask, Are our political figures, our Senators, and our Congressmen so ignorant of the principles of international trade that they really believe the arguments they advance about the tariff, or are these contentions made for a purpose? While many of the arguments are no doubt made in all sincerity, it seems very unlikely that all of our political leaders are really deceived by some of the absurd statements about the tariff, unless it is true that a man can repeat a thing so often that, despite its falsity, he eventually comes to believe it himself.

Senators and Representatives are elected from states and from districts within states. Since the interests of the people as consumers are rarely considered in Congress, the business of each member of that body with regard to the tariff is to get as many favors as possible for the business interests of his district. Some businesses within a district may be making large profits behind the tariff wall, others may be dependent upon the tariff for their very existence, and still others may not be concerned at

all about it. In any case, the attempt is usually made to obtain protection for all. Many cases are on record of industries receiving a generous measure of protection where none was asked. Tariff advantages for one district can be obtained by members of Congress only by cooperating with other members desiring favors for their own districts. Whatever the method used, each member must look out for his own district, or powerful support will be withdrawn from him and at the next election he is likely to find himself one of the represented, instead of being himself a representative. Many tariff speeches are doubtless made as a justification of the actions of the members, and for popular consumption at home, to convince those who are not convinced and to reassure those who are.

The Attitude of Business Men.—The one discordant note in the hymn of praise for protection is the fact that many American business men are coming to view the tariff with doubt and fear. Of course, those whose businesses are dependent upon the tariff for large profits, or for their very existence, quite naturally continue to favor the policy of protection. Almost anyone in the same position would feel the same way. If a man knows that a certain policy is vital to his own interests, it is extremely easy for him to discover that this same policy is of the utmost importance for the welfare of the country as a whole.

On the other hand, the policy of protection is opposed by many of our great bankers, who sense that restrictions on imports are great obstacles to a continuation of our foreign investment policy and to the development of New York City as an international financial center. Farmers, too, are coming to suspect more and more strongly that they have little to gain and much to lose from continued attempts to "protect" them. Finally, the owners and managers of industries which are efficient in their own right, which do not depend upon the tariff, and which are able to meet world competition, are beginning to oppose the protective tariff. Being able to meet competition, these industries are anxious to develop their exports further and gain the markets of the world, but they find themselves greatly hampered in their efforts because we have refused to accept imports freely and thus have made it difficult for the people of other countries to buy from us.

Our Present Tariff Policy.—While conditions did not appear particularly favorable for a revision of our tariff policy despite business stagnation at home and the decline of our foreign trade, the Congress of the United States in 1934 enacted a law which seemed destined to go far toward modifying this policy. This measure, called the Reciprocal Trade Agreements Act, authorized the President to enter into reciprocal commercial agreements with other countries for the purpose of fostering international commerce. In such agreements, the President may modify existing import duties and other import restrictions in return for similar concessions from other countries. He may not, however, increase or de-

crease any duty by more than 50 per cent, or transfer articles from the dutiable to the free list, or vice versa. The agreements can be consummated only after reasonable public notice has been given of the intent to negotiate with the other countries, after public hearings have been held at which those interested may express their opinions about the prospective agreements, and after seeking information and advice from the United States Tariff Commission, and the Departments of State, Agriculture, and Commerce.

The policy expressed in the Act was pursued actively until the outbreak of war in Europe in 1939, by which time agreements had been drawn up with nineteen countries. These countries included Great Britain, Belgium, Sweden, Switzerland, Cuba, Canada, France, Czechoslovakia, and several South and Central American countries. It is not feasible for us to consider the details of these trade agreements, but we may examine briefly those concluded in 1938 with Great Britain and Canada. Under these agreements, the United States received tariff cuts or other concessions from Canada with respect to 1489 products, and from Great Britain with respect to about 450 products. Canada and Great Britain, in return, received concessions from the United States on about 450 and 150 products, respectively. The agreements affected American exports which in 1937 were valued at about \$440,000,000, and American imports amounting to some \$260,000,000 in that year.⁶ In signing her agreement with the United States, Great Britain acted for Newfoundland and about fifty non-self-governing colonies. At that time the United States transacted about one-third of her total foreign trade with the areas included in these agreements, and the three countries together (the United States, Great Britain, and Canada) accounted for almost one-third of the world's total international trade.

Appraisal of the Reciprocal Trade Agreements.—It is impossible to determine the exact effects of the reciprocal trade agreements upon the international trade of the United States. To do so would require a comparison of our actual volume of trade in recent years with the volume which would have been transacted in the absence of the trade agreements—and the latter, of course, is an unknown quantity. Our international trade is subject to so many influences that one cannot single out the specific effect of the trade agreements. Some people argue that our trade with all countries was probably affected in the same way by the general recovery of business in recent years, and insist that, if our trade has increased faster with agreement than with non-agreement countries, the influence of the agreements is indicated. However, this is not necessarily true. Our trade with Germany, for example, may have been reduced by resentment felt here over that country's handling of the Jewish people, her default on financial obligations, or her general program

⁶ *New York Times*, November 18, 1938, and *Chicago Tribune*, November 17, 1938.

of aggression. American trade with Japan may have been similarly affected at one time by our attitude toward her invasion of China and her treatment of Americans in the war area, and may later have been increased by her heavy purchases of war materials and supplies. Since Germany and Japan are both non-agreement countries, a failure to consider these matters would result in giving our trade agreements with other countries more or less credit than they deserve. It was true that, as compared with 1935, our 1936 trade with agreement countries increased roughly twice as fast as our trade with non-agreement countries, but since 1937 wars and preparation for war have disturbed our trade to such an extent that it is quite impossible to estimate the effects of trade agreements.

For the most part, then, the trade agreements must be approved or disapproved on general grounds. Other things being equal, they have a stabilizing influence on international trade. They tend to increase our trade by reducing tariff duties or making other concessions where they will do us the most good. Since it has seemed impossible to get many nations to lower trade barriers at one time, reciprocal trade agreements probably provide the best means available for increasing foreign trade by reducing trade restrictions. The objections to the trade agreements have come more largely from small business men than from our major industries. Small business men, who have no hope of developing foreign markets, have been disturbed by the increased importation of foreign products. In addition, our tariff-minded politicians and newspaper writers have made a determined effort to convince the farmers of the country that the reciprocal trade agreements are detrimental to agricultural interests. The farmers were told, at one time, that our imports of cheddar cheese had increased fifteen-fold under the auspices of our trade agreement with Canada. The implication was, of course, that they had been badly injured by this development, but the tellers of the tale forgot to add that, even after the increase mentioned, these imports amounted to only 2.2 per cent of the domestic production of cheddar cheese. Similarly, the farmers were urged to protest against great increases in our imports of cream, though these imports amounted, after the increase had taken place, to only one-tenth of one per cent of domestic production.⁷ In the field of manufacture, alarm was expressed over the trade agreements provision which permitted the importation of 4,800,000 pairs of shoes a year from Czechoslovakia, although these imports, if actually achieved, would have amounted to only $1\frac{1}{4}$ per cent of our domestic output.

The trade agreements program has been virtually at a standstill since the outbreak of the second World War. Some countries with which we had agreements have been wholly or partly swallowed up by Germany,

⁷ *Foreign Affairs*, April, 1938 pp. 428, 429.

while others have almost abandoned international trade except for the purchase and sale of war materials and supplies; merchant ships are kept busy with war activities; and few nations, if any, concern themselves with such relatively unimportant matters as tariffs and other peace-time obstacles to trade. It is evident that a genuinely reasonable policy with respect to international trade cannot be adopted until the world is free of widespread military conflict.

Interstate Barriers to Trade.—In the meantime, we may well give attention to the status of trade within the United States. Throughout our national life, we have taken freedom of trade within the country for granted, for our federal Constitution forbids any state to lay any imposts or duties on imports or exports, except as may be absolutely necessary for executing its inspection laws, or to lay any duty on tonnage without the consent of Congress. The rapid and prosperous economic development of our country has been attributable in no small measure to this internal freedom of trade, but since 1929 our individual states have placed many obstacles in the way of trade with other states. According to one source, 1489 laws setting up barriers to interstate trade went into effect between 1929 and 1939.⁸

These barriers to interstate trade take many forms. Under their taxing and licensing powers, states have provided:

1. Special taxes on certain products which compete with goods made within the state. For example, 30 states have tried to limit the sale of oleomargarine from other states, in order to protect producers at home.
2. Special taxes on certain types of business or merchandising units, such as chain stores.
3. Use taxes on articles that have been purchased outside the state to avoid a sales tax imposed within the state.
4. Taxes on non-resident commercial motor vehicles (trucks and busses). Such vehicles may be required to pay full license fees in the state, in addition to mileage and gasoline taxes.
5. Special taxes and fees on out-of-state corporations doing business within the state.
6. Licenses for traveling vendors (merchant truckers and canvassers).
7. Discriminatory premium taxes on out-of-state insurance companies.
8. Discriminatory liquor taxes which favor producers or dealers within the state.

⁸ J. E. Johnson, *Interstate Trade Barriers*, New York, H. W. Wilson Company, 1940, p. 23.

In using their police powers, or attempting to protect the health, safety, morals, or general welfare of their citizens, some states have provided:

1. Restrictions on milk markets, by limiting the supply in certain city markets, and employing other restrictive measures.
2. Exclusion of certain plant and animal products by quarantine or inspection laws.
3. Restrictions on movements of workers into the state, by requiring workers to prove their ability to support themselves.
4. Regulations of weights, dimensions, and equipment of interstate trucks and busses, or requirements that such vehicles enter the state through certain established "ports of entry." The former regulations have varied so much from one state to another that it has sometimes been necessary to violate the law of one state in order to comply with the law of another.
5. Grade, standard, or label requirements not conforming to federal specifications or those of other states.

Acting under corporate or proprietary state powers, some states have provided:

1. Requirements excluding all but legal residents of the state from the public payrolls.
2. Laws requiring the expenditure of public funds within the state (in the case of such goods as coal, building supplies, or printing).
3. Regulations limiting or forbidding the exportation of products of state natural resources, in an attempt to force industries to locate within the state.⁹

Breaking Down State Barriers.—The above description represents the state of affairs which existed in 1939. Since that time, the governments of many states have recognized the seriousness of this kind of interference with interstate commerce; and, as a result of interstate conferences, a strong counter-movement has developed. In 1939 and 1940, very few laws erecting barriers to interstate commerce were passed, and many old laws were repealed. State barriers to interstate commerce have no sound economic basis. Other measures—for example, quarantine or inspection laws—may sometimes be necessary, but their operation should not be permitted to violate our traditional policy of free trade as between the several states. With that policy reinstated and firmly enforced, we may decide to experiment more extensively with the lowering of trade barriers between the United States and other countries of the world. Indeed, we may even see the day when employers and workers alike will decide that

⁹ Most of this material on state barriers to interstate commerce has been summarized from F. E. Melder, "Trade Barriers Between States," *Annals of the American Academy of Political and Social Science*, January, 1940, pp. 54-61.

the story of the benefits of protection should be pulled down from the shelf of works on economics and placed among the fairy tales where, for the most part, it indubitably belongs.

1. How would the absence of tariff restrictions tend to maximize the gain which the nations of the world could derive from international trade?
2. Would you favor the protective tariff from the point of view of the welfare of the world as a whole? Why?
3. Should we retain the protective tariff because of the revenue which it produces for the federal government?
4. Could we, by means of the tariff, monopolize the domestic market and maintain our export trade at the same time?
5. "The superiority of one country over another in a branch of production often arises only from having begun it sooner. There may be no inherent advantage on one part, or disadvantage on the other, but only a present superiority of acquired skill and experience. A protecting duty, continued for a reasonable time, may permit the country which lacks this skill and experience to carry on the industry until the producers are educated up to the level of those with whom its processes are traditional." Comment on this argument for the protective tariff.
6. "We are importing at the rate of about \$300,000,000 worth of foreign goods per month into the United States. Most of these goods could be made here. There is not a manufactured article produced in the United States in which the labor cost is less than 90% of the total cost following the raw material from start to finish. Now, if that is true, of the \$300,000,000 that we are sending abroad each month to buy foreign-made goods, \$250,000,000 is going out from the people of the United States to employ German, French, English, Japanese, and Chinese labor, while our own workers walk the streets in idleness. Unless adequate protection is secured against foreign-made goods, there is little hope of this country being able to maintain the present standard of living of the American workingman and woman."
- Is this a valid argument for the protective tariff? Why?
7. Is the protective tariff effective as an instrument for shielding a country from outside economic influences and for promoting economic stability? Why?
8. Would the efforts of nations to be economically self-sufficient be more or less likely to promote world peace than would the economic cooperation and interdependence of these nations? Why?
9. What is meant by the "scientific tariff"? Explain. Would you favor a tariff law of this kind? Why?
10. "Domestic industries may be protected indirectly as well as directly." How?
11. Why may import quotas be more effective than protective tariffs in certain situations? Explain.
12. How may foreign exchange controls be operated to afford protection to domestic industries?
13. "Foreign exchange controls may be set up for many purposes but they often restrict trade and protect domestic industries." Do you agree? Why, or why not?
14. Discuss the relative merits of foreign exchange controls and protective tariffs.

15. Compare clearing agreements with foreign exchange controls proper.
16. Show why there is now no point to condemning the protective tariff on the ground that it endangers the position of the United States as an outstanding creditor nation.
17. Do you think our tariff policy should be affected by the fact that many of our exports are now manufactured goods?
18. Explain fully why it has been so difficult in the past to obtain a downward revision of our tariff.
19. State the major provisions of the Reciprocal Trade Agreements Act of 1934.
20. "The reciprocal trade agreements program has been condemned as being too effective." Explain.
21. Show why the effects of the reciprocal trade agreements program on our international trade are difficult to measure.
22. Why is the reciprocal trade agreements program virtually at a standstill at present?
23. "While we have been worrying about international obstacles to trade, a host of interstate barriers to trade have been erected." Explain.
24. What should be our attitude toward barriers to interstate trade? Explain.

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CHAPTER 41

FOREIGN INVESTMENTS AND INTERNATIONAL INDEBTEDNESS

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WE BEGIN our study of foreign investments and international indebtedness by examining the general principles on which international loans and investments, and exports and imports of capital are based.

THE ECONOMIC EFFECTS OF A NET OUTFLOW OR INFLOW OF CAPITAL

The Meaning of an "Export of Capital."—In considering the process by which international indebtedness is incurred, we should recognize that, in speaking of international movements of capital, the word "capital" is being used in a somewhat different sense from that in which it is ordinarily used by economists. Its usual definition is "produced goods intended for further production"; that is, capital is a part of those scarce, material, and transferable goods that are commonly called "wealth." When borrowing takes place between nations, however, the capital that is imported and exported consists, in the first place at least, of purchasing power or claims upon wealth, rather than articles of wealth themselves.

What happens whenever the individuals or governments of foreign nations obtain loans in the United States—or, to look at it from the other point of view, whenever we make investments in foreign securities or properties—is that purchasing power, such as bank deposits, formerly owned by citizens of this country is turned over to foreigners or foreign governments. A part of this purchasing power must be spent in the United States for the banking services in connection with the loan, while another part may be spent here if this country appears to be the most advantageous market for the particular commodities desired by the borrowers or if the terms of the loan provide that a certain part is to be spent here. It usually happens, however, that a considerable part of such loans is—for a time at least—wanted by the borrowers in some other form than commodities and services. Even though, in the last analysis, the borrowers in many cases will want commodities and services, their immediate desire is usually to obtain most of the loan in the currency of their own country, to be used there, or to obtain commodities and services from some country other than the one that extended the credit.

The borrowers' problem, then, becomes that of transferring purchasing power from the lending country to their own country. This may be accomplished by having their agent in the lending country use their credit balances to buy bills of exchange on the borrowing country and send them to the borrowers, or by themselves drawing bills of exchange against their balances in the lending country and selling the bills at home. Conceivably, their balances in the lending country could be used to buy gold there, which could then be transferred to the borrowers.

A Persistent Net Capital Outflow and the Foreign Exchange Market.—When a country has a persistent net outflow of capital, the problem of transferring the funds becomes serious. The borrowers' attempts to convert the funds by buying bills of exchange in the lending country add to the already existing demand for drafts on the borrowing country or on other countries not directly involved in the lending. On the other hand, their attempts to transfer funds by selling at home bills of exchange on the lending country add to the supply of such exchange already existing in the borrowing country. Since the increased demand in the lending country for exchange on the borrowing country, and the increased supply in the borrowing country of exchange on the lending country, would persist because of the continuing loans, the effect would be to raise in the lending country the exchange rate on the borrowing country and lower in the borrowing country the exchange rate on the lending country. These changes in exchange rates seem likely to result ultimately in a flow of gold from the lending to the borrowing country, although other conditions may intervene to render this flow unnecessary during a greater or lesser period of time.

For example, it is probable that dealers in foreign exchange in the lending country can set up credit balances in the borrowing country through short-term advances by the banks there, and can sell additional exchange on the borrowing country by drawing bills against these balances. It is also entirely possible that the central bank of the borrowing country may intervene and offer to give the borrowers funds in the borrowing country in exchange for the claims against credit balances held by the borrowers in the lending country. The purpose in doing this, from the central bank's point of view, may be to prevent an inflow of gold when such a flow appears undesirable because of conditions either in the borrowing country or in the international credit situation, or to obtain foreign exchange which may be counted as a part of legal banking reserves in some countries. Either type of banking activity, however, will be indulged in only so long as it appears desirable with regard to banking, reserve, and gold conditions at home and abroad; and when these activities cease, a flow of gold tends to take place.

The Effect on International Trade.—If the flow of gold toward the borrowing country, because of a persistent capital movement, is so large

A Persistent Net Inflow of Payments on Account of Long-term Indebtedness.—International loans, however widely some may appear to differ from others, are all alike in one respect, in that they make it necessary for payments to pass from the borrowing to the lending country on account of interest or dividends, and eventually in the repayment of principal. The longer a country has had a persistent net outflow of capital funds, the greater are the sums it must receive annually, and the more difficult will it be for the country to keep on lending enough to make the net flow of payments on the capital account move outward. Eventually the time comes when, from the standpoint of the lending country, the inward payments on account of existing indebtedness, added to the payments representing new investments of foreigners in the lending country, will exceed the exports of capital being made by the lending country, and the net balance of payments on account of long-term indebtedness will be inward, and not outward.

When this happens we may expect the same sequence of events as has already been described, except that the country which is being repaid will be in the position formerly occupied by the borrowing country. The need to transfer net payments to the former lending country operates to increase both the demand for foreign exchange in the repaying country and the supply of exchange on the repaying country in the one that is being repaid. The rate of exchange on the creditor country rises, while that on the debtor falls. Eventually, after the banks in each country have gone as far as appears wise in facilitating the transfer of funds, a flow of gold to the former lending country may be expected. Despite all steps that can be taken by the central banking system of the creditor country, some expansion of its purchasing power—that is, an expansion of its money and deposit currency as compared with that of the debtor country—may be expected. This relative change in purchasing power will, as before, influence imports and exports, tending, directly or indirectly, to increase imports to the former lending country and to increase exports from the debtor country, regardless of whether or not the price level rises in the creditor country and falls in the debtor country.

In ending this description, we may refer once more to the qualifications of this broad statement of theory which it might be desirable to present were this discussion more extended. Our conclusion is, nevertheless, that a country that is receiving a persistent net inflow of payments on account of long-term indebtedness will have an "unfavorable" balance of trade—that is, an excess of imports in terms of commodities, services, and gold taken together—and that repaying countries will tend to be affected in the opposite manner. This changed relationship of imports to exports in the country that is being repaid may come about through a growth in imports while exports remain constant, through a decline in exports while imports remain constant, or through a change in

both; and the same is true of the repaying country. It does not follow that the country that is being repaid will necessarily have an increase in imports from or a decrease in exports to the country that is repaying, or that the latter must have an increase in exports to or a decrease in imports from the country that is being repaid. These things may happen, or they may not. But we know that the country which is receiving net payments *must* have an import balance of trade in terms of gold, commodities, and services taken together, from whatever source derived, and that the reverse is true for the repaying country.

THE UNITED STATES AS A CREDITOR NATION

The First World War Period.—Up to the year 1916 the United States was a debtor nation. At the beginning of the first World War, we, as public and private debtors, owed individuals of other countries approximately 5½ billion dollars, while foreign individuals and governments owed individuals in the United States about 2½ billion dollars.¹ Between 1914 and the end of 1919, the United States made huge loans, both public and private, to many countries, and as a result found herself an international creditor to the extent of about 18 billion dollars. This sum, however, represented the nominal value of foreign obligations to this country rather than the actual value, which was probably about 14 billion dollars in view of the adjustments finally made in the war debt obligations of the Allied governments to this country. In addition, allowance should be made for our obligations to other countries, amounting roughly to 4 billion dollars; so that the net actual indebtedness of individuals and governments throughout the rest of the world to individuals in, and the government of, the United States at the close of 1919 was almost 10 billion dollars.²

The 1919–30 Period.—The growth of the United States as an international creditor did not end in 1919. While our government ceased to lend to other governments a few years after the close of the war, the private investments of our citizens in foreign securities and properties continued at a merry pace until, by the end of 1930, it was estimated that the total indebtedness of foreign governments and individuals to the United States government and individuals in this country amounted roughly to 22 billion dollars.³ This figure, however, did not include our investments in Alaska, Hawaii, and Puerto Rico, or in missionary and educational institutions abroad, or any *short-term* obligations due individuals in this country. If we deduct from this estimate some 4 billion

¹ R. A. Young, *The International Financial Position of the United States*, New York, National Industrial Conference Board, Inc., 1929, p. 3.

² *Ibid.*, pp. 48, 49.

³ United States Department of Commerce, Bureau of Foreign and Domestic Commerce, *A New Estimate of American Investments Abroad*, Washington, Government Printing Office, 1931, pp. 1, 2.

dollars, which was approximately our indebtedness to foreign countries in all but short-term obligations, there remained a net indebtedness to the United States of about 18 billion dollars, as we noted in the preceding chapter.

The War Debts.—The fact that the United States was so great an international creditor in 1930 caused considerable concern, especially in view of the traditional high-tariff policy of this country. One of the most disturbing elements in the situation was the matter of the war debts. After the United States entered the World War in April, 1917, loans to the Allied countries consisted largely of direct advances from our government to their governments, as authorized by the various Liberty Loan Acts. It was these direct intergovernmental loans that resulted in the war debts. In making these loans, funds held by individuals and organizations in this country were turned over to the United States government through the purchase of Liberty Bonds. This government then placed the funds, or credits, at the disposal of the Allied powers as needed for the purchase of materials and supplies, the stabilization of foreign exchange rates, and for other purposes.

It may be asked how the United States could make these huge advances totaling billions of dollars, to the governments of the Allied countries in so short a space of time. A large part of the answer, at least, lies in the fact that credit within the United States underwent a marked expansion during this period. The inauguration of the Federal Reserve System made possible a large expansion of credit through its low reserve requirements and rediscount provisions. Before we entered the war, much gold was shipped to this country by other nations, and this provided the legal basis upon which to build a large superstructure of credit. After we entered the war, the Federal Reserve Board followed a very liberal policy in making advances to the government and rediscounting commercial paper, and even made it possible to rediscount promissory notes secured by government bonds.

This expansion of bank credit served to increase the money incomes of all classes of people, and made available for investment a great aggregate volume of savings, with which foreign securities and Liberty Bonds could be bought, and domestic securities could be repurchased from foreign holders. Thus, our government was given purchasing power which it subsequently turned over to the accounts of the borrowing governments. In terms of commodities, these savings and loans meant that, while our own physical production of goods was increasing to a marked degree, our citizens were economizing in their use of commodities and were thus making possible a surplus for export.

The war loans, which resulted in the war debts, differed from ordinary international loans in at least two important respects. As we have already noted, these loans were made by our government directly to the govern-

ments of the countries with which we were allied, whereas foreign loans are ordinarily made by individuals or companies in one country to individuals or companies in other countries. Hence, the war debts constituted a political, as well as an economic, problem in all the countries involved. In the second place, the proceeds of the war loans were used for purposes of destruction, so that their expenditure did not provide the means of repayment by adding to the productive capacity of the borrowers. Ordinary loans, of course, are made primarily for productive purposes. Since the war, the war debts have been so hedged about by considerations of a moral or ethical character that any attempt to consider them from a purely economic point of view would fail to take into account many important matters related to the question of repayment.

The Funding Agreements and War Debt Statistics.—Several years elapsed after the first World War before arrangements were made for repaying the war loans. The first "funding" agreement, or arrangement for payment by installments over a long period of years, was concluded with Great Britain in 1923. Other funding agreements followed, until by 1927 the largest debtors of the United States had made arrangements to settle their war debts. The total nominal funded indebtedness of our debtors on account of war loans proper, purchases of surplus war supplies, purchases from the United States Grain Corporation, and relief credits, was 11,468 million dollars in November, 1928. To clear up this indebtedness, the debtor nations were obligated to pay some 20,938 million dollars, on account of principal and interest, between 1929 and the end of the debt-paying period, about 1987. The value of these scheduled payments, as of 1929, was 7870 million dollars, with the future payments discounted at 4 per cent, or 6538 million dollars at the rate of 5 per cent.⁴

Could the Debtor Countries Have Made the War Debt Payments?—By 1930, the question of the hour was whether the debtor countries could and would make the annual payments specified by the war debt funding agreements, and whether the United States could receive these payments. The annual payments had been arranged on a sliding scale, becoming heavier as time went on. In the period 1929-34, they amounted to 256 million dollars per year. Postponing, for the moment, the question of whether such payments could have been transferred to the United States year by year, let us consider whether the debtor countries could have collected the necessary sums from their citizens, presumably by taxation. In the case of the four largest debtors—England, France, Italy, and Belgium—the annual per capita payment on account of the war debts would have been somewhat less than the \$2 per capita which it would have meant to the people of the United States, but it would have had to be collected under very different conditions. For one thing, the per capita

⁴ R. A. Young, *The International Financial Position of the United States*, pp. 192, 193.

income of these countries was appreciably lower than that of the United States. England's per capita income was approximately two-thirds that of England, and of the United States, but France's was less than that of England, and Italy's much lower still. Moreover, in the debtor countries taxes already absorbed a much higher percentage of the national income than in the United States in ordinary years. Clearly an annual per capita burden of a given amount had quite different implications under these widely varying conditions of income and taxation. But the fact that the creditor country is rich and the debtors are poor has no effect on the debtors' legal obligation to pay. The same conditions, in fact, often exist between individual debtors and creditors. On the other hand, there can be little doubt that the conditions mentioned above were important in considering the likelihood of war debt payments.

Was There a Moral Obligation to Pay?—The war debts were binding on the United States would hardly have cared to go to war to collect payments of 256 million dollars a year. It was often said that the pride of the debtor nations in meeting their obligations and living up to their word would insure payment of the war debts. It is true that a nation will often go to great lengths to keep from defaulting on an obligation which it considers just, but it is questionable whether its people will make similar sacrifices to meet an obligation which they regard as unfair from an ethical or moral point of view.

The debtor countries apparently felt that they were under no moral obligation to pay these debts. The debts were contracted after our entrance into the war—after the war had become our cause as much as that of our Allies. The advances should be regarded, not as loans which took no interest, but as expenditures for the security and defense of the United States quite as much as for that of any of the Allied countries—in other words, they were contributions to a common cause. The United States entered the war in April, 1917, but at that time she had no troops that could be sent into the trenches. It was sixteen months before our army began to play an active part; but in the meantime, the troops of the Allies fought for themselves and for us, while we furnished supplies and money for ourselves and for them. Each country gave labor. Each country gave the lives of those in the front. It was a simple case of division of labor. The only difference was that while the lives of those in the front were expressed in the legal form of a loan, our advances of money and supplies to these countries were not.

In addition, it was claimed that the language used by members of Congress in discussing the war-time advances to the Allies showed plainly that they were to be regarded as contributions rather than loans. One Senator had said, "I am perfectly willing to give to any of the Allied nations the money which they need to carry on our war, for it is now our

war. I would give it just as freely as I would vote to equip our army or maintain our navy." Said another, "We can [by the advances] effectively and in the immediate future, arm, strengthen and support those who are, since our declaration of war, fighting our battles." Such utterances were many.

The arguments from a moral point of view had no legal standing whatsoever, for the war debts were valid, legal obligations. They were definite and unequivocal, and were undertaken voluntarily by the Allied governments. They had signed on the dotted line, and we were merely holding them to their word. The important thing at law is what is said *in* legislation, not what is said *about* it before it passes. Nevertheless, it is true that considerations of an ethical character influenced the Allies in their attitude toward the payment of the war debts.

Discrimination in the Debts Settlements.—Another factor which may have affected the willingness of debtor countries to make payments was the discriminatory nature of the war debt settlements. In arranging these settlements, an attempt was made to observe the principle of ability to pay, but it appeared later that the attempt was unsuccessful. Who, for example, would have said, a few years after the settlements, that Great Britain was twice as able to pay interest on her war debt as France, or eight times as able as Italy? Yet the interest rates were in these proportions. Similarly, it seemed unfair that Italy should have been required to pay only 25 per cent of her nominal debt, discounting the future payments at 5 per cent, while France was obligated to pay 50 per cent, Belgium 54 per cent, and Great Britain 78 per cent.

War Debts and Reparations.—It soon became apparent that the governments of the debtor countries could not, as a matter of political expediency, tax their citizens in order to make war debt payments to the United States, unless they continued to receive their reparations payments. By "reparations" we mean those payments which Germany was obligated to make her opponents in the first World War for loss and damage to which the Allied and associated governments and their citizens were subjected by Germany. Some payments were to be made by other countries, but these were relatively unimportant. The first "settlement" of the reparations question in 1921 obligated Germany to pay a total of about 32 billion dollars, covered by "A" bonds of 3 billion dollars, "B" bonds of 9 billions, and "C" bonds of 20 billions. Of these, only the "A" and "B" bonds were really taken seriously by most observers. When Germany proved unable to continue payments under this plan, a new arrangement, the "Dawes Plan," was brought into operation in 1924. This plan called for annual payments of 596 million dollars by Germany, to continue indefinitely. Finally, in 1929, the "Young Plan" was evolved, under which Germany was to pay annuities for 37 years, ranging from a low of about 401 million dollars in 1931 to a high of 578 millions in 1965.

Thereafter she was to be liable for 22 further payments, averaging some 400 million dollars per year.⁵

In connection with both war debts and reparations, we should bear in mind that the amount to be paid each year, rather than the total amount, was the most important consideration in attempting to pass upon the feasibility of payment and collection of these obligations. Table 46 shows

TABLE 46.—AVERAGE ANNUAL PAYMENTS TO BE MADE TO THE UNITED STATES BY DEBTOR GOVERNMENTS, AND AVERAGE ANNUAL REPARATIONS PAYMENTS TO BE RECEIVED BY THESE GOVERNMENTS, 1930-1934

(Sources: R. A. Young, *The International Financial Position of the United States*, p. 199; and D. P. Myers, *The Reparation Settlement, 1930*, p. 179)

Country	Average Annual Payment to the United States on Account of War Debts (in millions)	Average Annual Receipt from Germany on Account of Reparations (in millions)
Great Britain.....	\$170	\$ 95
France.....	52	211
Italy.....	13	44
Belgium.....	8	24
All Others.....	13	45 (including payments to U. S.)
Total.....	\$256	\$419

the average annual amounts which were to be paid by the principal debtors to the United States on account of the war debts in the years 1930 to 1934, and the amounts to be received by these countries in reparations payments in the same years. There is good reason for presenting these figures together, in spite of the fact that the United States consistently maintained that war debt payments were in no way connected with or dependent upon reparations payments. For an examination of these figures shows that, except in the case of Great Britain, the reparations payments, if made, would have furnished the debtor countries with more funds than necessary to make their war debt payments to the United States.

Could the United States Receive the War Debt Payments?—For years, many people insisted that the United States would experience little difficulty in receiving the annual war debt payments, because of their relatively small amounts. While 256 million dollars a year, the annual average payment due from 1930 to 1934, is a large absolute amount, it is only a fraction of one per cent of the annual income of this country in good years and bad, and less than 6 per cent of our imports in 1929. But the war debt

⁵ The statistics on reparations are from D. P. Myers, *The Reparation Settlement, 1930*, New York, World Peace Foundation, 1930, pp. 57-59; and R. A. Young, *The International Financial Position of the United States*, pp. 182-185.

payments could not be considered by themselves, for we would have had to receive these payments in addition to all other payments which have to pass from other countries to this country year by year. In 1930, our private foreign investments amounted to about 15 billion dollars. A yield of 5 per cent on these investments would have required the acceptance of about 750 million dollars a year by this country, if investors were to receive interest payments and dividends. -

The Necessary Import Surplus.—These incoming payments would have been offset to some extent by outgoing payments on account of the investments of foreign countries in the United States. However, the total payments to be received from abroad in each year would have amounted to a huge figure. These incoming payments count as exports in our balance sheet of international payments. That is, they bring about a situation like that which results from a heavy exportation of a commodity (say, wheat), which would also require foreigners to make payments to this country. Therefore, if we were to receive these payments on account of foreign indebtedness, our total imports of commodities and services would have had to exceed our other export items (which required payments to us) by the amount of the war debt payment and investment payments to us. It would have been necessary, in other words, for us to have received a heavy surplus of imports, apart from the war debt payments.

Under other conditions it might have been possible for us to achieve this necessary import balance of trade, but in 1930 our high protective tariff made it practically impossible to accept the necessary imports. Moreover, generally high tariffs and other obstacles to trade throughout the world made it difficult at that time for the debtor countries to export enough to set up the necessary balances abroad, against which bills of exchange could be drawn to make payments to us. It appears, therefore, that our policy with respect to international trade was inconsistent with our position as an outstanding creditor nation, and threatened to destroy the value of our public and private loans and investments abroad. But, it may be asked, could not the United States have achieved the import balance of trade essential to the payment of foreign debts without lowering the tariff and increasing the importation of dutiable articles? It is true, of course, that an import balance of trade might have been obtained by reducing exports, as well as by increasing imports, but it is difficult to believe that this alternative would have been popular with the rank and file of American business men. If it had been possible to increase greatly our net imports of services, this country might have received large net payments on account of long-term indebtedness without much change in commodity imports. However, it did not appear that any great or sudden expansion in these service items could be looked for at that time. Certain "invisible items," such as tourists' expenditures, might have been expected to increase as time went on. Other items, such as the remit-

tances of immigrants and payments for freight services, were more likely to decrease, the first because of our immigration policy, and the second because of agitation for the development of an American merchant marine. All in all, no great amount of relief could have been expected from this quarter.

Payments to the United States Before 1930.—But, it may be asked, were not war debt and reparations payments made and received in the years before 1930, and did not the United States in those years also receive large payments from abroad on her private loans and investments? The answer is really negative in both cases. Between 1924 and 1930, Germany paid reparations to the amount of 10,300 million Reichsmarks. In order to do this, we might assume on general principles that she had an export surplus of about the same amount, and thus acquired the necessary foreign balances against which the reparations payments were drawn. Actually Germany had in this period an *import* trade balance amounting to 6300 million Reichsmarks. The large reparations payments were possible in the face of this import trade balance only because, in the same period, Germany had borrowed 18,000 million Reichsmarks.⁶ These loans came, to a considerable extent, from the United States. Thus, through borrowing abroad, Germany acquired the foreign balances with which to make reparations payments to the Allies. When these balances came to the Allied nations, they were able to make war debt payments to the United States, despite their inability to export to us, and our inability or unwillingness to import from them to any great extent. The reparations and war debt payments in these years amounted fundamentally to our taking large quantities of funds from one pocket and returning smaller quantities to another pocket.

To determine whether the United States actually received large annual payments on account of private loans and investments abroad, in the years before 1930, it is necessary to consider all of the several items that result in payments into or out of this country, on account of long-term indebtedness. Among the outgoing items there are payments on account of imports of securities (both new issues and those outstanding), investments of Americans in foreign properties, government advances to foreign governments, and redemption and sinking fund payments and interest and dividends on our securities held abroad. Among the incoming payments are included those on account of outstanding securities exported, investments of foreigners in properties in the United States, the principal of our government advances and credits returned, interest and dividends on our private investments, interest on our government advances, and the redemption and sinking fund requirements of foreign securities held by us.

⁶ *The Economist*, London, England, Supplement on the War Debts, November 12, 1932.

When the incoming annual payments are compared with the outgoing payments on the long-term capital account from 1919 to 1930, a fairly good balance of the two movements of funds is observed. For a few years after 1919, there was a net outflow of payments from the United States, but somewhat later there developed a tendency for incoming payments to be slightly in excess of outgoing payments. On the whole, then, there was no real net inflow of payments on our foreign loans and investments in this period. Instead, we maintained and increased the net indebtedness of other nations to us by, in effect, *reinvesting* the amounts due us on account of interest, dividends, and the repayment of principal. Individuals in the United States, of course, received such payments when due, but we as a people refused them, or at least canceled their effects, by making every year a net balance of new foreign investments and loans of substantially the same amount as we received on account of old loans and investments. All in all, the creditor position of the United States did not appear very secure as of 1930.

THE PRESENT INTERNATIONAL LOAN-INVESTMENT POSITION OF THE UNITED STATES

The Elimination of the War Debts.—Since 1930, the creditor position of the United States has virtually disappeared. The first step in the process was the complete loss of the value formerly attributed to the war debts—7 billion dollars as of 1930. When the depression of 1929 came and Germany's foreign sources of credit dried up almost overnight, she was in a serious position, for her heavy borrowings obligated her to make large annual payments on her private foreign debts, in addition to her reparations payments. Confronted by the depression and by high tariffs and other obstacles to trade which other countries were maintaining, Germany could not expand her exports sufficiently to acquire foreign balances for purposes of debt payment; nor could she provide the necessary export balance of trade by reducing her imports.

By 1931, it appeared likely that Germany, if left to her own devices, would have to default on her private debt payments to other countries, and on reparations payments as well. This would have meant loss to many private investors in the United States, and the non-payment of war debts by our former Allies because of Germany's failure to pay reparations. Acting on the principle that half a loaf is better than no bread, President Hoover proposed that, for one year dating from June, 1931, all war debt and reparations payments should be suspended. The other nations concerned eventually agreed to this proposal. In this way, a default on private debt payments due American citizens was temporarily avoided.

In the summer of 1932, the Lausanne Agreement gave Germany permanent relief from her reparations obligations, although this abandon-

ment of reparations was presumably contingent upon a like action by the United States with respect to war debts. Actually it meant the end of reparations, despite the fact that this country took no official action on the war debts. Nevertheless, Germany eventually defaulted on her private debt payments to other countries, by a series of steps taken in 1933 and 1934. Since the abandonment of reparations, the countries which owe us war debts, with the single exception of Finland, have persistently refused to meet these obligations and there now seems to be no hope that the war debts will ever be paid.

Decline in the Value of Our Private Investments Abroad.—The private investments of American individuals and firms in foreign countries, which were estimated at 15 to 15½ billion dollars in 1930, amounted to some 13 billion dollars at the beginning of 1935.⁷ But this latter figure does not show the true extent of the decline which had taken place in the value of our private investments abroad. These investments are divided into direct investments and portfolio (or security) investments. Direct investments are those which involve direct participation in commercial and industrial enterprises abroad, such as investments in American controlled manufacturing and distributing organizations, mining properties, petroleum lands, plantations, and other properties. The portfolio investments include all our holdings of foreign securities, either publicly offered in this country or secured through purchase in the international market. The direct investments of almost 8 billion dollars at the beginning of 1935 represented the book value of these investments as reported by their owners at the end of 1929 with allowances for additions and deductions since that time, while the figure of over 5 billion dollars for portfolio investments represented the par value of the securities.

While the estimate of direct investments allowed for changes in the quantity of these investments, it apparently did not allow for changes in their value, which must have declined appreciably by 1935 as a result of the depression. However, when the depreciated foreign values of these properties were converted into depreciated United States dollars, it is quite possible that the estimate given for these investments was about right. But this conclusion can scarcely apply to the portfolio investments. Since most of these securities were already expressed in terms of dollars, they could not benefit by conversion into devalued dollars; and the actual value of the securities was probably much less than their par value by 1935, because of total or partial defaults by the debtors on many of the securities.

The Geographical Distribution of Our Investments.—Table 47 shows the geographical distribution of the private long-term foreign investments of the United States as of the beginning of 1935. We see that by far the greater part of our private foreign investments were in the western

⁷ *Barron's Financial Weekly*, September 16, 1935, pp. 5, 6.

hemisphere. Canada was the most important single debtor country, our investments there being slightly larger than those in the whole of Europe, and considerably larger than those in South America. Germany was our largest debtor in Europe. It will also be noted that in Canada and South America our direct investments exceeded the portfolio investments, whereas in Europe the opposite was true.

TABLE 47.—THE GEOGRAPHICAL DISTRIBUTION OF THE PRIVATE LONG-TERM FOREIGN INVESTMENTS OF THE UNITED STATES AT THE BEGINNING OF 1935

(Source: *Barron's Financial Weekly*, September 16, 1935, pp. 5, 6)

Area	Direct Investments (in millions)	Portfolio Investments (in millions)	Total Investments (in millions)
Canada.....	\$2,120	\$1,780	\$ 3,900
Europe.....	1,479	2,391	3,870
Central America and Mexico.....	855	43	898
South America.....	1,546	1,394	2,940
West Indies.....	975	135	1,110
Africa.....	129	2	131
Asia.....	433	400	833
Oceania.....	156	252	408
Total.....	\$7,693	\$6,397	\$14,090
Add: Bank capital.....	125		
Deduct: Net repurchases by foreigners.....		1,100	975
Net Total.....	\$7,818	\$5,297	\$13,115

The Rapid Changes Since 1935.—The position of the United States in the field of international loans and investments has been changing rapidly since 1935, and the net result has been a large flow of capital funds to this country. This movement had as its origin a number of economic and political factors in the United States and elsewhere. In 1936 and 1937, improved business conditions in the United States led citizens of foreign countries to invest in American stocks and bonds. Disturbed economic and political conditions in France after 1935 resulted in a flight of capital funds from that country, and a large part of these funds came to the United States. The devaluation of the belga in 1935 and of the franc in 1936, together with other difficulties of the gold-bloc countries, was accompanied by a movement of short-term funds to the United States. Other large quantities of short-term funds moved here as a result of the European political and war crises of 1938 and 1939.

The statistics of the period from January, 1935, to September, 1939, indicate that American banks and brokers reduced their funds held in foreign countries from \$1,234,000,000 to \$532,000,000. On the other hand, the funds held by American banks and brokers for foreign customers increased from \$679,000,000 to \$3,195,000,000. Foreign holdings

of stocks and bonds of the United States increased from \$2,089,000,000 to \$3,200,000,000, while American holdings of foreign dollar bonds were reduced from \$5,296,000,000 to \$3,950,000,000. Since it required a flow of only \$677,000,000 to the United States to reduce our holdings of foreign bonds by \$1,346,000,000, it is clear that these securities were disposed of at prices which averaged about 50 per cent of par. In September, 1939, foreign-owned direct investments in the United States amounted to \$2,435,000,000, while direct American investments in foreign lands totaled \$7,100,000,000.

The net creditor balance of the United States was changed by these developments so that, by September, 1939, it amounted to only \$2,752,000,000. At that time, the long-term investments of the United States in foreign countries amounted to \$11,050,000,000, while our short-term investments abroad totaled \$532,000,000. On the other side of the ledger, foreign long-term investments in the United States were \$5,635,000,000, and short-term foreign investments here were \$3,195,000,000.⁸ The movement of capital funds into the United States continued throughout the remainder of 1939, and in 1940 there was an additional net movement of some \$2,500,000,000 into this country.⁹ Hence, as of the beginning of 1941, our short- and long-term obligations to other countries just about equaled their short- and long-term obligations to us.

The Functions of Foreign Investments.—Foreign investments in the United States consist, to a considerable extent, of short-term funds which have been sent here temporarily for safekeeping, while our investments in foreign lands are almost all of the long-term variety. Therefore, the United States still has a substantial creditor position, if only long-term investments are considered. When normal world conditions are restored, a large part of the foreign short-term funds now held here will probably be withdrawn, and the United States is likely to extend her creditor position. However, while our accounts are temporarily in balance, it might be well to reexamine the functions of foreign investments and our general position with relation to such investments. Despite our mistakes of the past, there are legitimate functions to be performed by foreign investments. They aid in developing new countries and backward areas. Thus they facilitate the extension of international specialization, or division of labor, and make for an increase in world production, markets, and trade. Foreign investments also contribute to the maintenance of an international financial system, based on the gold standard. They help to smooth out temporary disequilibriums of imports and exports, to distribute the

⁸ These statistics for the 1935-39 period are from A. Maffry and P. D. Dickens, "The Balance of International Payments of the United States in 1939," reprinted from the *Survey of Current Business*, February, 1940, Washington, Government Printing Office, 1940.

⁹ *Survey of Current Business*, February, 1941, p. 55.

world's gold supply among the nations, and to stabilize foreign exchange rates. They are, or might well be, a tie binding the nations of the world together.

Our past mistakes in making foreign loans and investments are fairly obvious. We have bought risky, high-interest foreign bonds from issuing governments already overburdened with public and private obligations to other countries. We have bought the bonds of countries which were notorious as graveyards for foreign investments, and as defaulters on their obligations. In short, we have loaned to foreign governments when we would never, as private business men, have extended credit to prospective domestic borrowers under similar conditions. We have been willing to purchase the securities of foreign companies with high-sounding names without any real knowledge of their financial condition, present business, and future prospects. Undoubtedly, there is a certain glamour about a foreign investment, but glamour scarcely compensates the investor for the loss of principal or interest, or both. Even our direct investments abroad have sometimes indicated poor judgment, if nothing worse. However, these mistakes may be merely those of a country inexperienced in investments, and may conceivably be avoided when we are more experienced.

Our Future Policy.—As we have said, the United States is likely to reappear as an international creditor once the present unsettled world conditions become stabilized, but there is grave question whether we should make a serious attempt to extend our creditor position in the future. Under certain conditions, an extension through new loans and investments might be economically wise and beneficial. One of the most important of these conditions is a modification of our tariff policy. To make large new loans and investments abroad, while maintaining our old high tariff policy, would be decidedly unwise. If we did this, the new loans and investments would for a time make it possible for this country to export heavily while importing lightly. Eventually, however, the annual payments to be received on account of old loans and investments would exceed, by a large sum, our new annual loans and investments, and the safety of our creditor position would be gravely endangered. Surely, in the light of experience, we should realize that we must not extend our creditor position unless we are willing to accept the responsibilities of a mature creditor nation, which include the lowering of tariff duties and the acceptance of an import balance of trade.

Another essential condition, if we are to extend our creditor position, is an improvement in foreign investment judgment and standards. Our investors must learn that a poor investment is not sound merely because it is made outside the United States. They should understand that foreign investment is always risky, and in appraising prospective foreign investments should apply standards which are even more severe and rigid than

those applied to domestic investments. Possibly our federal attempts to control the activities of investment bankers, as described in Chapter 35, will improve the quality of foreign securities offered to our investors. Investors in foreign securities and properties must also be given to understand that they invest at their own risk and that the United States government in no sense guarantees the safety of these investments, or of those who administer them.

The extension of our creditor position should wait upon the stabilization of monetary systems and of foreign exchange rates among the nations of the world. Private foreign investment will probably remain at a standstill until prospective investors know, with a fair degree of certainty, at what rate the earnings of foreign properties can be converted into dollars, and what the dollars will be worth when they get them; and until they are assured, further, that some foreign dictator will not destroy the value of their investments by taking over the direct control of properties or forbidding the payment of interest on foreign-owned bonds. If we feel that internal economic conditions make it imperative for the United States to continue to use a managed currency, so that the dollar has no fixed value in terms of foreign currencies though it may have a stable purchasing power at home, the prospects of our making large new foreign loans and investments of a private character may be anything but bright.

While we have not been making large new *private* loans and investments abroad for some time, the federal government of the United States has made large war loans to foreign countries. Under the terms of the Lend-Lease Act of 1941, we have sent armaments, materials, and supplies to Great Britain, China, Greece, and other countries which have sought our aid in fighting aggression. The total amount of aid that will be given under this Act is indefinite, but will undoubtedly run into many billions of dollars. The means by which these advances may be made and repaid are highly flexible under the Lend-Lease Act, and the new debts are not likely to be so formal in character as those of the first World War. In view of our experience with the old war debts, it would seem more realistic to regard these new advances as gifts than as collectible loans.

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1. What is meant by an "export of capital"?
 2. How does a persistent net outflow of capital affect the foreign exchange market? How does it affect international trade?
 3. What are the economic effects of a persistent net inflow of payments on the long-term capital account?
 4. In what respect did the international financial position of the United States change between 1914 and 1919? Between 1919 and 1930? Explain.
 5. How were the first World War debts created?
 6. "The war debts to the United States differed from other international debts in some respects." Do you agree? If so, why?
 7. Describe the war debt funding agreements, and the several "settlements" of the reparations question which occurred prior to 1930.

8. Was it economically possible for the debtor countries to make the annual payments required by the war debt funding agreements?
9. "Some of the most important influences affecting the willingness of the debtor countries to pay the war debts were considerations of an ethical or moral nature." Describe and evaluate these considerations.
10. In what respects did our war debt funding agreements discriminate as between the several debtor countries?
11. "The war debt payments and reparations payments were closely connected, in a practical sense." Explain.
12. Could the United States have received the war debt payments under a continuation of her traditional tariff policy? Explain.
13. Show how the necessity of receiving large annual payments on account of private loans and investments abroad complicated the problem of receiving the war debt payments for the United States.
14. "The fact that war debt and reparations payments were made and received, prior to 1930, indicates that they could have been made and received after that date." Do you agree? Explain.
15. Explain carefully the significance of the private foreign loans and investments made by the United States between 1919 and 1930.
16. "Since 1930, the creditor position of the United States has virtually disappeared." Explain.
17. What happened to the war debts after 1930, and why?
18. Distinguish between "direct" and "portfolio" investments.
19. Why did the actual value of the private foreign loans and investments of the United States decline after 1930?
20. Show how certain developments from 1935-39 affected the creditor position of the United States.
21. What are the functions of foreign investments? Explain.
22. What grave mistakes have we made in the past in the field of foreign investments?
23. Under what conditions might we consider it economically wise to extend our international creditor position in the future?

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CHAPTER 42

THE ECONOMIC INTERDEPENDENCE OF NATIONS

MANY puzzling economic problems have arisen from the fact that population tends to expand while the amount of land, including in this term all natural resources, is fixed. Well over a hundred years ago, when Thomas Robert Malthus was formulating his statement of the tendency of population to outrun the means of subsistence, it appeared that the population of Great Britain and other countries had nearly reached the maximum which could be supported. The present population of Great Britain, however, is about four times that which had appeared so large at the beginning of the nineteenth century, while the population of the world as a whole has approximately tripled in the same period of time.

INDUSTRIALIZATION AND ECONOMIC INTERDEPENDENCE

In fact, at the very time that Malthus was writing, a movement was under way which was to go far toward affording a solution for the difficulties which he saw and feared, although the solution brought with it new problems, among which is that discussed in the present chapter. The movement referred to was the speedy growth of industrialization, and its early events were so spectacular that it has long been called the Industrial Revolution.

The Case of Great Britain.—It is a well-known fact that a country of given size and resources can support a much larger population through industrialization than through agriculture. Great Britain, for example, had great difficulty in providing food for her relatively small population a century or more ago. In recent years, however, she has been able to support many more people on a considerably higher standard of living. This has been accomplished by getting from other parts of the world one-half to two-thirds of her foodstuffs, as well as large quantities of other basic materials, such as petroleum, copper, lead, wool, cotton, sulphur, aluminum, zinc, rubber, manganese, nickel, chromite, tungsten, potash, phosphates, antimony, tin, mercury, and mica.¹ The chief economic activity of Great Britain, apart from the mining of coal, has been manufacturing. The manufacturing industries have provided enough

¹ P. T. Ellsworth, *International Economics*, New York, The Macmillan Company, 1938, p. 504.

goods to supply the domestic market, and still leave a large surplus to be exported in payment for heavy imports of raw materials and foods.

German Industrialization and Dependence.—The industrialization of Germany has developed since the formation of the German Empire in 1871. Since that time, Germany has experienced a growth of more than 50 per cent in population,² the concentration of large masses of the people in urban districts, the development of a wide variety of manufacturing industries, a tremendous expansion in foreign trade, and the formation of many large business combinations, or cartels. These changes made it possible for the increased population of the country to enjoy a higher standard of living than prevailed in former years, but this progress was obtained at a cost. That is, Germany in pre-fascist days was dependent upon other countries for a fifth or more of her food, including as much as half her total consumption of fats, and for large quantities of industrial materials as well. She has had abundant domestic supplies of coal, nitrates, and potash, and less adequate supplies of iron ore, lead, and zinc, but has had to import all or almost all her petroleum, copper, sulphur, aluminum, cotton, wool, rubber, manganese, nickel, chromite, tungsten phosphates, antimony, tin, mercury, and mica.³

The Position of the United States.—Economic self-sufficiency is probably most nearly realized in the United States, but even this country is dependent upon others for a wide variety of essential products. As the industrialization of the United States has become more complete, the trend in our imports has been more and more toward raw materials and foods and away from manufactured products, while the latter have become an increasing part of our exports, replacing raw and semi-finished goods. The United States can produce all the coal, iron ore, petroleum, copper, lead, sulphur, cotton, zinc, phosphates, and mica she needs; is less well supplied with nitrates, aluminum, wool, and mercury; and must import rubber, manganese, nickel, chromite, tungsten, potash, antimony, tin, and other essential raw materials.³ We are at least partly dependent upon other countries for tea, spices, coffee, tobacco, wood pulp, hides, silk, jute, hemp, sisal, quinine, and iodine.

The Problem of Economic Interdependence.—As we have seen, it has been decided in many countries that the economic welfare of their large and growing populations could best be cared for by placing their chief economic reliance on manufacturing. This has made it necessary for these countries to look to other lands for large quantities of foodstuffs and raw materials for manufacturing, both because no country is suited for pro-

² Statements in this introductory section, relating to population and resources, describe the situation which prevailed prior to Germany's attempt to establish a "New Order" in Europe.

³ P. T. Ellsworth, *International Economics*, p. 504.

ducing all essential materials for itself, and because in many of them the soil cannot be made to furnish sufficient food to provide for the needs of the very dense populations. At the same time, markets for large quantities of manufactured products must be found in other countries, so that payments for the incoming foodstuffs and raw materials can be made.

Large-scale production has become the rule in the industrial countries and has made possible the realization of many economies. On the other hand, however, it has required large investments of capital and has brought heavy fixed costs, which make it imperative that the industries be operated continuously and as close to full capacity as possible. This, in turn, has made it necessary that the flow of raw materials be ample and constant, and that markets be ever available in which the products of industry can be sold. The dependence of the nations of the world upon each other for raw materials and markets, and their struggles to obtain and to retain control over these materials and markets, constitute the problem of the economic interdependence of nations.

THE QUEST FOR COLONIES AND CONCESSIONS

With several nations undergoing a process of rapid industrialization at one time and realizing more and more keenly the need for foreign markets and importations of raw materials and foods, it is not surprising that these countries cast many a covetous eye at the more backward areas of the world, which seemed capable of furnishing markets and materials, and possible homes for surplus populations. However, the needs of the industrial countries were so urgent that these nations declined to leave the development of backward areas to chance or to a competitive struggle between the rivals. Instead, each country sought to reserve areas for its exclusive colonial development. This does not mean that all colonies have been established because the mother countries needed foods, materials, markets, and relief from population pressure, for many other motives—sentimental, religious and political—have led to colonization. It may safely be said, however, that these economic needs were a major factor in the struggle for colonies which marked the last few decades before the first World War.

Results of the Search for Colonies.—As so often happens in economic and other contests, the most advantageous positions in the colonial field were taken by the early comers. The process of industrialization began first and developed most rapidly in England, and it forced an early recognition of the need for outside sources of food and raw materials, as well as for outlets for surplus population and manufactured products. The securing of colonies was considered to be the simplest means of satisfying these wants, and through colonization the British Empire was made to grow by leaps and bounds. It is today, if considered as an economic

colony. Preferential tariffs exist, or have existed, between Spain and her colonies, Portugal and her colonies, France and some of her colonies, and within the British Empire.

Preferential duties, however, are not always on imports. Preferential export duties are often applied to raw materials, and are a menace to amicable trade relations between nations. The purpose of such duties may be in part to encourage shipping and trade, but it is primarily to stimulate industry in the mother country by furnishing it with raw materials upon favorable terms. A preferential export duty is simple in application. A certain amount is collected for each unit of the raw material exported, and a part or the whole of this amount is given back if the destination of the export is the mother country, or if it can be shown that the next process in the utilization of the material will be or has been performed in the mother country or another colony.

One example of a preferential export duty is that of India on untanned hides and skins. In 1919 an export duty of 15 per cent was applied to these articles, and a rebate of two-thirds of this amount was allowed on exports to be tanned within the British Empire. This preferential duty affected American tanners adversely, aroused much resentment, and caused considerable trade to be diverted to other markets. The duty was changed in 1923 so that it affected all countries equally.

As has been said, preferential tariffs are often ineffective because even the preferential rates are so high that little advantage is given to the country that is nominally favored. To the extent that a real benefit is conferred, ill feeling and retaliation by other countries are likely to result. The President of the United States, for example, has the power to impose additional duties on or even to exclude products coming from any country which discriminates against our commerce.

Assimilated Tariffs.—When the tariff policy of the mother country toward the colonies is that of assimilation, discrimination against other countries is complete, for under this policy the colonies are made a part of the mother country for tariff purposes. This means that colonial raw materials, which are subject to an export tax when shipped to other countries, pass to the mother country without interference. At the same time, both colonies and mother country may send goods to each other without fear of import duties, while goods from other countries attempting to enter either mother country or colonies run up against the tariff wall of the mother country, within which the colonies are included. The policy of assimilation has been applied by the United States to Puerto Rico, Hawaii, and Alaska, and by France to many of her colonies.

Protectorates.—When industrial nations have deemed it impossible or unwise to secure complete control over a backward area through colonization, they have been able at times to accomplish some of their ends through the development of protectorates. A protectorate exists when one state, usually by treaty, gives to another and stronger state a considerable

world has been particularly keen since the importance of petroleum in the operation of warships and other ocean vessels, as well as in its many uses on land, has become apparent. Access to adequate oil resources now appears to be almost a matter of national life or death. Great Britain, besides being closely affiliated with the Royal Dutch-Shell oil interests and insisting that the Turkish Petroleum Company's operations shall be British-controlled, owns a majority of the shares of the Anglo-Persian Oil Company.⁵ This company has a blanket concession which gives it control, until 1961, over the oil resources in all of Persia except five northern provinces. It also owns in part the Burma Oil Company, which is prominent in the Burma field where the British have a monopoly. Concessions for the development of the oil resources of Mesopotamia have changed hands several times. These resources have been exploited by a British-controlled company, with American and French oil companies participating.

The Netherlands is directly interested in the Royal Dutch-Shell group, which has a practical monopoly of petroleum production in the fields of the Dutch East Indies, as well as important concessions in South and Central America. While the government of the United States is not so directly interested in American oil companies as are the governments of Great Britain and the Netherlands in their respective companies, it is nevertheless true that our government is much concerned over the difficulties experienced by American companies in gaining a foothold in the newer oil fields which hold much of the oil supply of the future.

The development of many of the important mineral resources of the world has taken place under concessions. In China, Mexico, and Latin America, concessions have been granted for the exploitation of minerals by outsiders. The rich resources of Central Africa, which include copper, gold, diamonds, tin, iron, bauxite, and many other minerals, are also being developed under concessions of enormous size, held chiefly by companies under the control of Belgian and British capitalists.

Modern Imperialism.—The international struggle for raw materials, markets, and outlets for surplus population is not a thing of the past, for we have recently had examples of imperialism. Some industrial nations are still trying merely to obtain economic control over areas that are economically backward, but others are apparently ready and willing to annex, or control politically, any areas which they can seize.

In September, 1931, Japan overran Manchuria and Jehol Province in China, and soon acquired control over some 365,000 square miles of territory, much fertile agricultural land, mineral resources, and a population of 30 to 34 million people. Later, the area was set up as a nominally independent state under the title of Manchukuo, but there can be no ques-

⁵ C. K. Leith, *World Minerals and World Politics*, New York, McGraw-Hill Book Company, Inc., 1931, pp. 87, 88.

tion that it had become, in effect, a Japanese province. Again in 1937, and presumably because of an anti-Japanese "incident," Japanese armed forces invaded China and have since conquered large additional sections of the country. According to Jāpan, her activities in China were purely defensive, but this is clearly an attempt to dress up the wolf of imperialism in sheep's clothing. The Japanese attacks on the Philippine and Hawaiian Islands, British Malaya, and the Dutch East Indies, as well as the occupation of French Indo-China and Thailand, in 1941 and 1942, indicate that Japan's lust for power was far from satisfied by her gains in China.

In October, 1935, Italy undertook to "protect" Italian lives and property from the "barbaric" Ethiopians, and to avenge certain "border outrages" which had proved humiliating to the national honor of Italy. By May, 1936, she had conquered the whole of Ethiopia in "self-defense," and annexed the area to Italy. This conquest brought Italy an area of 350,000 square miles, with a population of 10 millions and extensive agricultural and mineral resources. A little later, Italy found it necessary, for similar reasons, to conquer neighboring Albania, securing an additional 17,500 square miles of territory and about a million people. Her gains in Ethiopia were wiped out in 1941, when the British succeeded in driving the Italians out of that area.

Imperialism, 1939-41 Model.—Far more extensive are Germany's territorial gains since 1939. Deprived of her colonies under the Versailles Treaty, and with her vital foreign trade virtually ruined, Germany under National Socialism has risen in her military might to seize food, raw materials, markets, and "living room" in general. By actual military conquest or by intimidation, Germany has brought Norway, Denmark, Belgium, the Netherlands, Austria, Czechoslovakia, Hungary, Roumania, Bulgaria, Yugoslavia, Greece, much of France and Soviet Russia, Poland, and some smaller areas under her dominion. For some purposes at least, Germany may be said to control the "unoccupied" portion of France. If she could retain all of the regions over which she has gained formal control, her area would be increased by more than a million square miles, and her population by several hundred million people.

THE RESULTS OF IMPERIALISM

In general, we must conclude that the results of imperialism have been unsatisfactory. Nations have gained much by industrialization and by drawing upon other parts of the world for food, raw materials, markets, and relief from population pressure, but they have gained little through their attempts to reach these ends by annexation or similar measures. In support of this conclusion, let us examine in turn the advantages which nations are supposed to derive from their colonies or other controlled areas.

Relief from Population Pressure.—In many cases, the colonies acquired by industrial nations have served but poorly as outlets for surplus population. As one writer puts it, Italy exhausted herself for many years before the first World War to obtain colonies, but when in 1914 the war broke out there were only 8000 Italians in all of her African colonies—a smaller number than lived within a radius of a quarter of a mile of Cherry Street, New York City, and only two per cent of the Italian population of the State of New York.⁶ He suggested that, if Italy had both control over Ethiopia and freedom of immigration to the United States, 500 Italians would come here annually for every one that went to Ethiopia.

Germany's experience was similar, according to this writer. By 1914 she had only 22,000 German colonists in her 900,000 square miles of African colonies, and only 2000 more in all the rest of her colonies. At the time, there were more than 24,000 Germans between 80th and 90th Streets on Manhattan Island, and 25 times as many in New York State. Japan, at a cost of 300,000 men, won South Manchuria from Russia in 1905. Twenty-five years later there were only 200,000 Japanese in this territory, or fewer than were killed in the war, and only one-third of the annual increase in the population of Japan.

There is considerable evidence to show that the inhabitants of advanced countries are much more likely to move to other independent civilized countries than to their own colonies. Many colonies acquired by nations in recent years are almost uninhabitable for the people of these nations, or are already densely populated by natives. Even when conditions in the mother country and colony appear to be fairly similar, it is often difficult to stimulate emigration. Thus, the Japanese declined to emigrate to South Manchuria because of lower standards of living there, because the climate was somewhat more rigorous, and because their favorite food, rice, could not be grown readily in all parts of the colony—and this despite the expenditure of large sums by the Japanese Oriental Development Company to encourage emigration. Of course, some nations acquired colonies long ago which were more suitable for colonization, but most of the recently acquired colonies have failed to attract large numbers from the mother countries.

We may also note here the fact that the nations which, in the last few years, have talked most and loudest about the pressure of population and the need for room to expand—such as Italy, Japan, and Germany—are not, after all, unusually densely populated. Before entering upon their campaigns for expansion, these three countries had a population of 133, 135, and 140 persons, respectively, to the square kilometer, while Holland,

⁶ Nathaniel Peffer, "The Fallacy of Conquest," *Harper's Magazine*, January, 1936, pp. 129-136.

England, and Belgium had 232, 264, and 266, respectively.⁷ There were, to be sure, some differences between these countries in their per capita holdings of arable land and natural resources. But it is likewise true that those countries which complained most about population pressure seemed to go out of their way to increase this pressure by attempting to raise the birth rate.

Food and Raw Materials.—The value of colonies as sources of food and raw materials has been somewhat greater than their value in providing relief from population pressure, but even here it is easy to overestimate their importance. While access to raw materials is vital to industrial nations, it should be remembered that colonies do not grant monopoly privileges, but merely give the mother countries first claim upon such materials, plus some profit from their exploitation. Very seldom do the colonies of any one country have anything approaching a complete monopoly over an important raw material or resource; and even if they should have exclusive control, the abuse of such monopoly power would almost surely lead to retaliation by other nations. Control over raw materials is of little use to an industrial country unless it has markets for its manufactured products, and these depend upon the development and efficiency of its industries. If a country is so efficient industrially that it can command foreign markets, it can usually secure its raw materials and foods more cheaply by purchasing them in the world markets than by conquering and developing colonial sources of supply.

Indeed, individual industrial countries have seldom found themselves discriminated against in the matter of access to foods and raw materials, except in times of war. Colonies often favor the mother countries in such matters, but usually furnish these products to all other industrial nations on equal terms. At times, the control of the raw materials of colonies has made things difficult for all industrial nations save the mother country, but not for any country in particular. But, it may be asked, are not colonial sources of supply important in time of war when other sources are cut off? The answer is that such sources of supply are of little value at such times unless the mother country controls water or land routes to its colonies, and such control is often exceedingly difficult to maintain.

Markets.—Colonies are of some value as markets for products of the mother countries, but here again their importance is easily exaggerated. Colonial trade is often captured by foreign countries which have the special advantages of unusual efficiency or of favorable location with respect to the colonies. We may cite, by way of example, the inroads of the Japanese textile industries upon the trade of the British colonies. Moreover, colonies in their original state are of little use as markets for the mother country; and an economic and industrial development which

⁷ *The Economist*, London, England, April 18, 1936.

would enable them to buy extensively from the mother country is likely on the contrary to make them better able to supply their own needs.

This point is illustrated by the fact that, by 1934, Japan was already reported to be uneasy about the development of new industries in Manchukuo which had begun to compete effectively with similar industries in Japan. Low wages in Manchukuo were said to have given that country advantages in the production of iron and steel, flour, soya bean products, and brewery products. Japan was particularly disturbed over plans for new cotton and wool mills in Manchukuo.⁸ In any case, the extent of colonial trade would be difficult to underestimate. In 1934, England's trade with her colonies, except those which are wholly or partly self-governing, amounted to only 10 per cent of her exports and 7 per cent of her imports, while Germany's colonial trade in the pre-war years of 1912 and 1913 amounted to but 6/10 of one per cent of her exports and 1/2 of one per cent of her imports.⁹

The Question of Concessions.—Concessions obtained by industrial nations in regions which are not politically controlled often appear to be economically justifiable. They may permit the development of backward regions, while retaining a considerable degree of control for, and bringing in some revenue to, the conceding government. To avoid controversy, they should be given for definite periods of time and for well-defined areas only, with adequate safeguards for the nations granting the concessions. It is particularly important, moreover, that they be granted according to the principle of the "open door." That is, the people of different nations should all have opportunities to obtain these privileges. When concessions are inexactly defined, and unequal opportunities are given to the people of different nations, international rivalry is stimulated and bitter diplomatic conflict often results, which may at any time lead to more serious international conflict. The United States has often been involved in trying to protect American concessions and concessionaires in backward areas from hostile treatment by the governments of these regions, or from the depredations of bandits or revolutionary elements. We have at times landed our marines and engaged in actual combat with armed forces which presumably endangered the safety of our properties and citizens, and have taken over or supervised the revenue systems of backward areas in order to safeguard our interests. Such activities are, of course, dangerous from the international point of view.

Final Estimate of Imperialism.—In general, then, the fruits of imperialism have not come up to expectations. Often the policies of industrial nations in backward areas have failed to bring these nations the expected economic advantages. And when successful in this respect, they have frequently led to international friction and ill feeling, and to the development of retaliatory policies and devices. Doubt and fear pervade

⁸ *The Economist*, London, England, June 9, 1934.

⁹ *Ibid.*, April 18, 1936.

the atmosphere in a world where the distribution of vital supplies of food and raw materials is left to such instruments as discriminatory tariffs, imperialistic policies for undeveloped areas, and monopolies and controls of raw materials. Moreover, international resentment is likely to lead nations to substitute a suddenly destructive course of action for one which is only gradually destructive of economic welfare. In other words, economic warfare may give way to military warfare, probably to the lasting detriment of all of the nations concerned.

THE CONTROL OF RAW MATERIALS BY PRODUCING NATIONS

Though our discussion has related specifically to the attempts of industrial nations to control sources of supply, we must not overlook the fact that the areas producing food and raw materials have themselves taken a hand in playing the game of restrictionism. While raw material *controls have sometimes apparently been set up by groups of individuals or companies in the producing areas*, it is usually true that the governments of these areas are genuinely, even if indirectly, interested in the proceedings.

The Conditions for Control.—The effective control of a raw material by producers is possible only if certain necessary conditions are met. In the first place, the commodity should be one which originates largely in a single country, although control has sometimes been made effective through the cooperation of two or more producing countries. Again, the material should be capable of being stored over considerable periods of time without deterioration, so that it can be withheld from the market indefinitely if necessary. Thirdly, the principal demands for the material should come from prosperous areas where the burden of rises in price which may occur will not be likely to stir up trouble for the controllers. Finally, the material should be such that new sources of supply cannot be developed except over a considerable period of time. Of course, if the commodity is a mineral which occurs almost entirely in a single area, potential competition is not much to be feared. Among vegetable products, however, those most easily controlled are commodities such as coffee and rubber, in which competition can develop only over the period of six or seven years which is required to bring a plantation into profitable operation.

The Purposes of Control.—The principal object of the control of most raw materials is revenue for both the government of the producing country and the individual producers of the goods in question. The government usually obtains its revenue through an export tax on the raw material. Such a tax is likely to be particularly heavy when the country has a virtual monopoly of the desired good, for then the burden of the tax will tend to be paid by the users abroad. Occasionally such a control

will take the form of a governmental monopoly, and in such cases the revenue for the government is derived from the enhanced prices which the control permits.

The revenue for the producers of the raw material comes from the high prices which they can charge when the production or marketing of the material is regulated under the control scheme. The participation of the government in the plan may run all the way from the mere collection and dissemination of information or the development of a plan for cooperation by the producers, to the passage of legislation for the restriction of output or the maintenance of prices. At any rate, the operation of control plans has often resulted in greater profits for the producers, or has at least permitted them to avoid losses which might otherwise have occurred.

Since these controls are almost never used by industrial nations, but are instead the product of regions which are economically undeveloped, a third purpose of control is sometimes present. This is to protect and encourage the domestic industry utilizing the raw material in question. Of course, the most common method of protecting an industry is to impose an import duty on the finished product. The same result, however, may be reached, especially when the raw material is largely located in one country, by insuring, through a control plan including an export tax, that the users of this material abroad will receive it on less favorable terms than domestic manufacturers. At times there appears to be no intention of building up an industry in the region producing the raw material. In such cases, if the region is a colony, the manufacturing industry in the mother country is often fostered instead by means of a rebate of a portion of the export tax applied to the raw material.

The Control of Raw Materials by Producers.—The various raw material controls may be divided into four groups, according to the degree to which the government of the producing country is interested in the plan. In some cases the control is left for the most part to the producers, with the government taking an indirect interest in the proceedings. An example has been the Chilean control of nitrates. Some form of nitrogen is essential in the production of fertilizers, dyes, drugs, and explosives. For many years the only large source of nitrates was the deposits of sodium nitrate in Chile, and the producers have long been organized for the control of this important material.

Their organization was called the Chilean Nitrate Producers' Association, and it controlled the production, sales, and prices of over 90 per cent of all sodium nitrate sold throughout the world. The policy of the Association has been, in general, to charge as high prices as the traffic would bear, and they have certainly been well above those which might have been expected to prevail under conditions of competition. Earnings on invested capital amounting to 25 to 50 per cent and higher have

been reported.¹⁰ The Association has also restricted production whenever it has been deemed necessary.

The Chilean government has manifested its interest in the industry in many ways. In 1919 and 1921 it approved the statutes of the Association, and it has assisted in bringing producers into the Association. The government has been represented by four members out of the eighteen on the Association's board of directors, and has assisted the industry through reductions in railroad rates and exemptions from import duties on the bags used in shipping nitrates. Nevertheless, the participation of the government in this control has not been so direct and obvious as in other cases in which raw material controls have been provided for by legislative enactment and governments have bought up and withheld supplies of raw materials from the market. It is also true that the heavy export duty imposed upon nitrates by the Chilean government has been a great burden on the industry at times. This duty has usually amounted to a third or a half of the export value of the nitrates. Though its incidence has probably been in part upon the producers, a large part has also been borne by the consumers, many of whom are in the United States. One writer states that this duty over a period of years has cost American consumers about ten million dollars annually.¹¹

Competition between Chilean nitrates and nitrogen from other sources became keen in 1927. Manufactured nitrogen, obtained from the air by a process of "fixation," is the principal source of this competition. Conditions became so serious in 1929 that a three-sided agreement was made between the Chilean Nitrate Association and English and German producers of synthetic nitrogen products. This combination controlled practically all nitrogen production for a time, and attempted to regulate production, divide up markets, and fix prices according to the best interests of the parties in control. However, the combination was less successful than the Chilean Nitrate Association of earlier years. One reason was that the United States developed facilities for producing large quantities of nitrogen, and could meet her requirements completely in case of emergency.

Raw Material Control by Legislative Enactment.—The severe depression in the rubber industry following the first World War, and the failure of attempts to promote voluntary cooperation among the growers, led to the passage of legislation in British Malaya and Ceylon in 1922 which has come to be known as the Stevenson Restriction Act. The purpose of the Act was to bring back prosperity to the rubber growers by raising

¹⁰ B. B. Wallace and L. R. Edminster, *International Control of Raw Materials*, Washington, Brookings Institution, 1930, p. 50.

¹¹ W. S. Culbertson, "Raw Materials and Foodstuffs in the Commercial Policies of Nations," in *Annals of the American Academy of Political and Social Science*, March, 1924, p. 80.

prices through the restriction of exports and control of production. The operation of the Act was somewhat complicated. Each plantation was assigned a "standard production" based upon its production for 1920, with allowance for new areas. "Standard production" for most estates probably ran around 80 to 85 per cent of capacity. Exportation at the minimum rate of export duty was permitted to each plantation up to a certain percentage of standard production. For greater amounts, the export duty became so heavy as to prohibit exports, for all practical purposes. The percentage of standard production which could be exported at the minimum rate of export duty varied as the price of rubber in London oscillated about a "fair price" per pound.

The Stevenson Act had the effect of restricting the output of rubber, at least temporarily, and also encouraged speculation in rubber. It was successful in stabilizing conditions in the industry and in bringing prosperity by raising prices, but just how much credit for the rise in prices should go to the Act and how much to other factors is not apparent. At any rate, the spot price of rubber in New York rose from a low of 13.9 cents a pound in August, 1922, to the high mark of \$1.048 a pound in November, 1925, and then fell to 18 cents in December, 1928.¹² During this period, immense profits were made by the rubber producers. Dividends for British rubber companies, which had ranged between 6 and 12.5 per cent in 1923 and 1924, varied between 17.5 and 55 per cent in 1925 and 1926. One estimate has it that this raw material control cost the United States about \$540,000,000 from 1924 through 1926.¹³ Part of this extra cost was borne by the manufacturers of rubber articles in this country and part was passed on to consumers.

The decline in the price of rubber after 1925 was the result of several forces. The anxiety of American industrial consumers over future supplies of this raw material was to some extent alleviated; world production of rubber was steadily increasing, especially in non-British areas where the control did not apply; and the demand for crude rubber was lessened by means of the greatly increased use of reclaimed rubber. The Stevenson Act aroused a chorus of protest, with the United States as chief protestant. The Act was finally repealed in 1928, when it became evident that it had outlived its usefulness. This does not necessarily mean, however, that all plans for the control of rubber are at an end.

Control Through Government Aid to Producers.—Probably the best example of this type of control was the Brazilian control of coffee. This plan was provided for by legislative enactment, but it differed from the control of rubber in that direct financial aid was given by the government to the coffee growers. After three successful "valorizations" of coffee, during which coffee was bought up and withheld from the market and re-

¹² B. B. Wallace and L. R. Edminster, *International Control of Raw Materials*, pp. 188, 189.

¹³ *Ibid.*, pp. 212, 213.

strictions were placed upon its export and the planting of new trees, a plan for the "permanent defense" of coffee was adopted. The law providing for such defense was passed in 1922, but the national government withdrew in 1924 and the measures for the protection of coffee were put into operation by the State of São Paulo (which produces 70 per cent of Brazil's output of coffee) in 1925. Control was placed in the hands of the Institute for the Permanent Defense of Coffee, which was composed of five members.

The main purpose of the permanent defense was the stabilization of prices through the regulation of the amount of coffee coming on the market. The State of São Paulo owned an extensive system of warehouses in which some 8 million to 12 million bags of coffee could be stored until market conditions permitted their sale. Planters were required by law to turn over all their coffee to the warehouses of the Institute, and at times were able to get as much as 75 per cent of its market value as a loan from the government. Funds for loans to the planters and for general expenses were obtained both by borrowing and by taxation.

By these methods it was possible for the Institute to maintain a high level of prices for some time. Until 1927 no great accumulation of coffee in the warehouses took place because world consumption was keeping pace with production. Beginning with the bumper crop of 1927-28, however, production far outstripped consumption, and prices could be maintained at anything like a satisfactory level only by amassing a tremendous surplus of coffee in the warehouses of the Institute. It was expected that by the middle of 1930 this reserve would be only just short of the amount annually consumed in the world. The strain proved too much for the credit of the Institute, and the price of coffee collapsed late in 1929. All Brazilian banks were in dire straits because of frozen assets, and the situation was saved only by obtaining an immense loan from abroad.

Following this emergency, control of the coffee situation was again taken over by the Brazilian government. In 1931, an export tax payable by the exporter was imposed on coffee, and the proceeds were used to buy up and destroy considerable quantities of low-grade coffee. This program was continued on a larger scale in 1932. In 1933, the coffee crop was unusually large and the government decreed that planters must turn over 40 per cent of the crop for destruction, at a price covering approximately the direct (variable) costs of production.¹⁴ In 1937, the government abandoned its attempt to control the prices of exported coffee; and, though the price fell, sales increased by more than enough to offset price decline. In 1938 and 1939, the planters gave up 30 per cent of the crop for destruction; and 25 per cent was destroyed in 1940. Coffee sold to the government for destruction was paid for at the very

¹⁴ J. W. F. Rowe, *Markets and Men*, New York, The Macmillan Company, 1936, pp. 43-46.

low rate of 2 milreis (10 cents) per bag. The State of São Paulo also bought coffee for destruction in 1940, and it was hoped that the quantity of new coffee placed on the market would be reduced from 20,000,000 to 11,500,000 bags, as a result of the two programs.¹⁵

Control by Governmental Monopoly.—It is only a step from control through a governmental plan, with public funds and facilities, to control by governmental monopoly. An example of the latter type of control is the Japanese camphor monopoly. Camphor is at present used chiefly for the making of celluloid, and the moving picture industry is consequently dependent upon it. Camphor is also an important element in the manufacture of pyroxylin products, including non-breakable or shatter-proof glass.

The monopoly control of camphor has been carried on with a dual purpose. It was desired, of course, to bring in revenue for the government, and it was hoped that the domestic manufacture of refined camphor and camphor products would be encouraged. The Japanese government has complete control of the industry. No one can go into the forests to collect raw camphor by distillation of the wood of the camphor laurel tree except operators licensed by the government. Thus both the quantity to be produced and that to be sold at home and abroad are arbitrarily determined. In addition, the government sets both the price for the sale of camphor and the price to be paid to the operators who collect it.

The monopoly was quite successful, for a time, in maintaining high and profitable prices. The price of camphor doubled within two years after the establishment of the monopoly, and prices were well maintained in the face of constantly growing production and sales. The power of the monopoly to set a high price has been greatly weakened in recent years by the competition of synthetic camphor. This product can be widely substituted for the natural camphor, and is even preferred for some purposes. Its production on a commercial scale at reasonable cost has resulted in a modification of the price policy of the Japanese monopoly.

Control by an Embargo on Exports.—More drastic even than monopoly control of a food or raw material is an embargo on the export of some material. Probably the example of an embargo of this kind which comes most promptly to American minds is the Canadian embargo on pulpwood. The object of such a restriction is not, of course, to bring in revenue for the government or to enhance the prosperity of the producers of the material, but rather to stimulate the growth at home of the industry which uses the raw material under restriction. For this purpose, an embargo may be very useful, but its effect upon a similar industry abroad may be serious.

The important restrictions were imposed by the provincial govern-

¹⁵ *Commercial and Financial Chronicle*, May 18, 1940, p. 3225.

ments rather than the Dominion government, and varied from one province to another. They were unanimous, however, in imposing embargoes on the exportation of pulpwood taken from crown lands. Sometimes the restrictions applied partially to pulp as well. At any rate, they made it necessary for pulpwood to be turned into pulp or even into paper before it could be exported. These embargoes have been a source of great anxiety to the American paper industry, especially in the East. Our domestic supply of pulpwood has in many districts become entirely inadequate, nor can it be moved for long distances to be manufactured because of the great cost. Many of our paper mills are dependent upon Canadian sources for much of their pulpwood, and if the embargoes should be extended to apply to pulpwood from all Canadian lands or to require the manufacture of woods into paper before exportation, serious results in this country might be expected. It is true, however, that the restrictions appear to have accomplished their purpose in Canada, for her exports have changed more and more from pulpwood to wood pulp and finished paper.

The Results of Raw Material Controls by Producing Countries.—These types of controls over raw materials have sometimes accomplished the desired results, and again they have not. On the other hand, they have been resented by countries that need these raw materials, suffer under the burdens imposed by the controls, and visualize a time when they may be cut off wholly from their raw material supplies. Like the measures used by imperialistic nations, raw material controls are a potent source of international friction and ill will.

International Raw Material Controls.—In many cases, the attempts of individual nations to obtain high prices for raw materials have been unsuccessful. This lack of success has usually resulted from increased production of the natural material or the development of synthetic substitutes. In recent years, international combinations or cartels have sought to control the production, marketing, and prices of foods and materials. International combinations, in their several fields, have been able to control the following percentages of the world output of certain materials: Copper, 95 per cent; bismuth, 90 per cent; zinc, 97 per cent; copra, 80 per cent; and whale oil, 80 per cent.¹⁶ These are but a few examples from a long list which includes steel, aluminum, potash, cement, dyes, mercury, tin, rayon, and rubber combinations.

Several advantages are claimed for international combinations. They are said to reduce the number of middlemen and the cost of their services; to eliminate cross-hauling, the unnecessary payment of import duties, and dumping; and to cut down advertising and selling expenses. However, the usual results of successful international combinations are restricted production, high prices, and large profits.

¹⁶ *Encyclopedia of the Social Sciences*, vol. xiii, p. 131.

FUTURE PROSPECTS OF GOODS CONTROL

The National Approach.—We have yet to consider what can be done about the problems resulting from the economic interdependence of nations. In general, little success seems likely to attend the efforts of any one nation to deal individually with these problems. The United States, for example, can do little when confronted by an international cartel which controls a material that we are unable to produce, or by a preferential tariff designed to exclude us from colonial markets—for the activities to which we take exception are carried on outside the jurisdiction of this country.

Action has sometimes been taken in the United States to try to improve the raw material situation, but little has been accomplished. Congressional investigations have been conducted and occasionally funds have been appropriated to promote the production in this country of materials which have been subjected to control by foreign countries. When public denunciation of some type of control has been particularly vigorous, the Department of Justice has brought suit against the American agents of foreign monopolies in the attempt to restrain their activities, but the suits have seldom been successful. The government has also been instrumental in preventing in this country the flotation of loans for the benefit of foreign material and food controls, but these loans have never failed of flotation in some other country or countries.

The principal nationalistic alternative to such feeble attempts at relief is retaliation, with control matched against control and restriction against restriction. As we have seen, however, retaliation is a dangerous policy. It almost never helps solve the original problems but, on the contrary, complicates them. There is no nation so strong that it can bring economic pressure to bear upon other nations without fear for itself, or so rich in economic resources that it can be highly prosperous without placing a considerable amount of economic dependence upon other nations. If each nation carried the control of foods, raw materials, and markets to the *n*th degree, the result would be the destruction of international exchanges, and economic disaster for all.

The International Approach.—In strict theory, it should be possible to solve the problems of the economic interdependence of nations through international cooperation. An approach of this kind might require the distribution of foods and raw materials by an international organization. That is, the ownership of the raw materials and foodstuffs of the world could be vested in a central organization which would distribute them equitably among the nations. A system similar to this was used during the first World War, but it would be difficult to get the nations to agree to it in times of peace. A second difficulty would be to build up a workable distinction between raw materials and other products. Most troublesome of all, however, would be the formation of principles of equitable

distribution, and decisions as to prices to be charged, when the total supplies of certain materials were concentrated in the hands of this central organization. These obstacles might not be insuperable, but it appears that a more helpful and comprehensive approach to this problem is available.

This approach is based upon an understanding of the principles of economic interdependence, and the benefits of free trade. Politically, the world consists of many units called nations, but for economic purposes the world should be regarded as a single unit. Cooperation among the national political units is essential if the economic welfare of all peoples is not to suffer. Under a plan of genuine cooperation, industrial nations would be assured access to foodstuffs and raw materials on terms of equality, and an opportunity to offer their products for sale in strictly competitive markets throughout the world. The benefits from free trade as outlined above would be greater and more cheaply secured than any gains which might possibly accrue from the adoption of imperialistic policies and adventures in restrictionism.

Past Progress.—Very little has been accomplished, since the first World War, in the way of bringing about international cooperation in these matters. To be sure, a diplomatic conference held at Geneva in 1927 produced a Convention for the Abolition of Import and Export Prohibitions and Restrictions. This agreement was signed by eighteen nations, which were later joined by the United States. These nations contracted to abolish, within a period of six months after the agreement went into effect, all import and export prohibitions and restrictions and promised not to impose them in the future. The convention did not apply simply to limitations of raw materials and foods, but to all kinds of restrictions, with the exception of import and export duties, and measures calculated to protect the public health and other vital national interests. However, the weakness of any agreement which does not deal with import and export duties is obvious.

National Economic Self-sufficiency.—At the present time, there is little prospect of securing international cooperation in economic matters. Indeed, the general movement has been away from such cooperation in recent years. Not only have the nations in general erected obstacles to international trade and exchange, as we have seen, but some have worked feverishly to attain national economic self-sufficiency. We shall examine this subject when we discuss the economic policies of Italy and Germany—two leaders in the movement toward national economic self-sufficiency.

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1. What has been the relation between population growth and industrialization?
 2. How have industrialization and the development of large-scale production led to economic interdependence among nations?

3. "The United States is economically self-sufficient and need not depend on other countries for her economic welfare." Do you agree?
4. Why have colonies been sought by the great industrial nations?
5. What two tariff policies have nations commonly adopted in connection with their colonies? Distinguish carefully between them.
6. What is the difference between a colony and a protectorate? Between a protectorate and a mandate? Explain.
7. What are concessions? Of what importance are concessions in our modern economic world?
8. "Imperialistic adventures of nations were confined to the last century and have not been known in recent years." Do you agree? Explain.
9. Have colonies generally been helpful to industrial nations in affording relief from population pressure? Explain.
10. How important have colonies been to industrial nations as sources of foods and raw materials? Explain.
11. "Colonies have usually solved the mother countries' problem of finding markets for manufactured products." Discuss.
12. How have imperialistic policies affected the relations between industrial nations?
13. Why have controls over raw materials been instituted by many countries producing raw materials? Explain.
14. Under what conditions are these controls most likely to succeed?
15. What has been the basis, in this chapter, for classifying controls exercised by producing countries over raw materials?
16. Give an example of each type of raw material control.
17. What have been the results of controls over raw materials by producing countries?
18. Why has the national approach to the problems of the economic interdependence of nations been both ineffective and dangerous?
19. What difficulties are involved in the plan for the international distribution of raw materials?
20. What progress has been made in the past toward the solution of the problems created by the economic interdependence of nations, and what are the present prospects of solving these problems through international cooperation?

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PART 7

GOVERNMENT AND ECONOMIC LIFE

CHAPTER 43

PUBLIC EXPENDITURES AND PUBLIC BORROWING

"GOVERNMENT," it has been said, "as a form of social organization, has developed because, in the long run, it has afforded the means of supplying men with certain services more efficiently and more economically than these could have been supplied by each for himself."¹ All economic systems of the present day are marked, to a greater or smaller extent, by division of labor. Each individual performs a single function, or a limited number of functions, and trusts to others to furnish him with the wide variety of commodities and services which he does not produce for himself. In the case of some services it seems the part of wisdom to look to the government for a more satisfactory performance than could be expected from private individuals or companies. The delegation of the provision of such services to and their performance by the government may be viewed simply as a part of division of labor.

The Nature of Governmental Functions.—These functions which are performed collectively rather than by individuals are of several kinds. Some services, such as furnishing protection or maintaining law and order, would be very difficult, if not impossible, for the citizen to perform for himself. Others that could be and sometimes are carried out by private companies are often turned over to the government in the hope that they will thus be performed more efficiently or cheaply. Examples are the provision of water and electricity by municipalities. Still other functions must be performed by the government, if they are to be done at all, because an individual's share in the resulting benefits is so small or so long deferred that he would not be moved by self-interest to undertake them himself. The establishment of institutions for dependents and defectives may be cited as an example. Even when an activity is left in the hands of private individuals, the government is often called upon to exercise a restrictive and regulatory influence. Thus we have a Pure Food and Drugs Act, a Sherman Anti-Trust Act, and other legislation designed to protect the interests of the public. The exact nature of the individual governmental functions will become apparent as we discuss the expenditures of federal, state, and local governments.

¹ H. L. Lutz, *Public Finance*, New York, D. Appleton-Century Company, Inc., 1936, p. 1.

Governmental Functions and Expenditures.—The functions of these governmental units, though they differ in many particulars, are alike in one respect. They all involve the expenditure of funds. There has been a marked tendency for public expenditures to increase during the past few decades, not only in the United States but in other countries, and for both the national and other governmental units. By public expenditures we mean the disbursements by the several governmental units in the performance of the functions intrusted to them. Many students of the question feel that the increasing activities and expenditures of governments constitute a problem of vital importance to every individual. The problem in connection with public expenditures is to decide to what extent we may best satisfy our desires by the collective utilization of our resources, natural and human, rather than by leaving to private individuals the task of providing certain commodities and services. That is, we must consider how large a part of our real incomes we wish to receive collectively rather than individually. For the purpose of convenience in discussion, however, we shall deal with the problem in terms of money.

INCREASES IN PUBLIC EXPENDITURES

Expenditures of the Federal Government.—Let us consider, in the first place, the increase in public expenditures in the United States and the nature of these expenditures in recent years. The expenses of our federal government increased from \$517,000,000 in 1903 to \$725,000,000 in 1913, \$3,437,000,000 in 1928, and \$12,774,000,000 in 1941.² The increase from 1903 to 1941 was 2371 per cent. However, even the enormous expenditures of 1941 were smaller than those of some years of the first World War, well below the estimated expenditures of \$22,269,000,000 for 1942, and very modest indeed when compared with the 1943 federal budget of \$58,927,992,300 presented to Congress by President Roosevelt in January, 1942.

Of the regular expenditures of the federal government, the largest single item is for protection (national defense), past, present, and future. The expense for national protection amounted to 39 per cent of the total expenditures in 1928, or 80 per cent if the expenditures for debt redemption and interest are included. The use of the larger figure might be justified on the ground that our national debt was large chiefly because the federal government, in certain past years, furnished protective services at a more rapid rate than could be covered by the ordinary governmental revenues of those years.

In 1941, as we see in Table 48, direct expenditures for national defense amounted to \$6,048,000,000, or almost half the total expenditures of

² *Report of the Secretary of the Treasury, 1928*, Washington, Government Printing Office, 1929, p. 418, and press release of the Treasury Department, July 2, 1941.

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TABLE 48.—EXPENDITURES OF THE FEDERAL GOVERNMENT, FISCAL YEAR 1941

Type of Expenditure	Amount Spent (in millions)	Per Cent of Total Expenditures
General governmental activities ^a	\$ 1,238	10.1
Assistance to agriculture ^b	970	7.6
Federal Loan Agency ^c	11	0.1
Federal Security Agency ^d	943	7.4
Federal Works Agency ^e	1,637	12.3
Tennessee Valley Authority.....	51	0.4
Veterans' Administration.....	553	4.3
National defense ^f	6,048	47.3
Revolving funds ^g (excess of credits, deduct).....	(136)	(1.0)
Transfers to trust accounts ^h	234	1.8
Interest.....	1,111	8.7
Debt redemption.....	64	0.5
Total Expenditures ⁱ	\$12,774	100.0

^a For regular governmental departments, reclamation projects, post office deficiency, refunds of taxes and duties, District of Columbia expenditures, river and harbor work and flood control, and the Panama Canal.

^b Includes the Agricultural Adjustment program, Farm Credit Administration, Rural Electrification Administration, Federal Farm Mortgage Corporation, Federal Land Banks, Farm Security Administration, forest roads and trails, and administration of the Farm Tenant Act.

^c Expenditures of the Federal Housing Administration and the Reconstruction Finance Corporation.

^d Expenditures of the Civilian Conservation Corps, National Youth Administration, and Social Security Board.

^e Expenditures of the Public Works Administration, Work Projects Administration, and other related agencies.

^f Expenditures for the army, the navy, the administration of Selective Service, emergency ship construction, the lend-lease program, and national defense housing.

^g Returns of funds from the Farm Credit Administration, Federal Farm Mortgage Corporation, and Public Works Administration.

^h Transfers to the Railroad Retirement account, unemployment trust fund, adjusted service certificate fund, and government employees' retirement funds.

ⁱ Source: Press release of the Treasury Department, July 2, 1941.

\$12,774,000,000. If expenditures for interest, debt redemption, and the costs of the Veterans' Administration are included, the total cost of national defense or protection amounted to about 61 per cent of all expenditures. This latter figure is not strictly accurate, because the federal government borrowed heavily to finance its expenditures during the post-1929 depression, and the interest on these depression debts, as well as on war debts, is included in the total interest paid in 1941. But in any case it is clear that a great part of our federal expenditures goes to pay the cost of past and present wars and to prepare for possible wars of the future.

Other large individual items of expense in 1941, such as \$970,000,000 for the Agricultural Adjustment program and other assistance to agricul-

ture; \$1,285,000,000 for the Work Projects Administration, and \$393,000,000 for the Civilian Conservation Corps and National Youth Administration; were carry-overs of certain depression activities of the government. Still other expenditures, such as \$423,000,000 for the Social Security Board and \$51,000,000 for the Tennessee Valley Authority, were for projects which, though undertaken during the depression, were not depression activities. The cost of maintaining the ordinary departments of government and of operating other regular agencies of the government amounted to only 10 per cent of total expenditures in 1941. Total federal expenditures in 1941 amounted to about \$97 per capita.

Expenditures of State Governments.—The state governments of the United States spent a total of \$182,000,000 in 1903, \$379,000,000 in 1913, \$1,889,000,000 in 1928, and \$3,433,000,000 in 1937.³ The increase from 1903 to 1937 was 1786 per cent. As we see in Table 49, state expenditures in 1937 were largely for purposes which have been traditionally classed as "developmental" and which are also called "general social welfare" activities. Items included are expenditures on highways, health and sanitation, charities, hospitals, corrections, schools, libraries, recreation, and the development and conservation of natural resources. Expenditures

TABLE 49.—EXPENDITURES OF STATE GOVERNMENTS IN 1937

(Source: *The American Yearbook*, 1940, p. 256)

Type of Expenditure	Amount Spent (in millions)	Per Cent of Total Expenditures
General government.....	\$ 151	4.4
Protection of persons and property.....	106	3.1
Highways.....	436	12.7
Health and sanitation.....	36	1.0
Charities, hospitals, and corrections.....	860	25.1
Schools.....	822	23.9
Libraries.....	3	0.1
Recreation.....	7	0.2
Development and conservation of natural resources	78	2.3
Interest.....	124	3.6
Capital outlays.....	707	20.6
Miscellaneous.....	103	3.0
Total Expenditures.....	\$3433	100.0

for general government and for the protection of persons and property were not large. Those for interest and capital outlays, while large, are not really a part of ordinary governmental expenditures for maintenance

³ Department of Commerce, Bureau of Foreign and Domestic Commerce, *Statistical Abstract of the United States*, 1935, Washington, Government Printing Office, 1935; and *The American Yearbook*, 1940, New York; Thomas Nelson & Sons, 1941, p. 256.

and operation. In the five years from 1932 to 1937, the expenditure for charities, hospitals, and corrections increased most rapidly. Expenditures for highways and schools also increased considerably. State expenditures in 1937 amounted to over \$26 per capita.

Expenditures of Local Governments.—It is difficult to obtain accurate estimates of the total expenditures of local governments because of the great complexity of these governmental units. However, we may get an idea of the trend in local expenditures by examining those of a group of 146 cities for which the United States Bureau of the Census collected statistics in the past. These cities spent a total of \$514,000,000 in 1903, \$912,000,000 in 1913, and \$2,952,000,000 in 1928. The increase during this period of twenty-six years was 474 per cent.* Statistics for this group of cities are no longer collected, but in 1938 the 94 largest cities of the United States spent a total of \$2,752,000,000. In Table 50, we see that the expenditures of these city governments are similar to those of the state governments. As might be expected, expenditures for general govern-

TABLE 50.—EXPENDITURES OF 94 LARGEST CITIES OF THE UNITED STATES IN 1938

(Source: *Financial Statistics of Cities, 1938, 1941*)

Type of Expenditure	Amount Spent (in millions)	Per Cent of Total Expenditures
General government.....	\$ 163	5.9
Protection of persons and property.....	346	12.6
Highways.....	112	4.1
Health and sanitation.....	187	5.0
Charities, hospitals, and corrections.....	508	18.5
Schools.....	625	22.7
Libraries.....	26	0.9
Recreation.....	65	2.4
Pensions.....	94	3.4
Contributions to public service enterprises.....	70	2.5
Interest.....	207	7.5
Capital outlays.....	377	13.7
Miscellaneous.....	22	0.8
Total Expenditures.....	\$2752	100.0

ment, protection of persons and property, and health and sanitation are somewhat heavier for city than for state governments, while the reverse is true of expenditures for highways and charities, hospitals, and corrections. The percentages of expenditures for education are about equal for both types of governments.

Reactions to Increases in Public Expenditures.—The great increases in public expenditures in this country have not escaped attention. The dis-

* Department of Commerce, Bureau of the Census, *Financial Statistics of Cities, 1928*, Washington, Government Printing Office, 1931, p. 31.

cussions of citizens, the speeches of politicians, and the editorials of our daily newspapers have dilated upon the astounding costs of government, the incompetence of public officials, and the prevalence of extravagance, graft, and the misuse of public funds. The arguments advanced at hearings of tax commissions, and the admonitions of men in high office, have dwelt upon the dangers of rapidly growing public expenditures.

The protests against the increase in public expenditures became increasingly bitter in the depression years after 1929. We were told that government was the fastest growing of our many industries, and that all would soon be government employees, if the numbers of those working for the government continued to increase. We were warned that increasing public expenditures make for an intolerable burden of taxation, and that, indeed, the current burden would be well-nigh unbearable if all our public expenditures were made with funds derived from taxation. The taxes collected by federal, state, and local governments in 1940 amounted to about \$109 per capita,⁵ or roughly one-fifth of the per capita national income, and these tax revenues failed by several billions of dollars to cover the total expenditures of these several governmental units. Since the beginning of the national defense program in 1940 the expenditures of the federal government have increased much more sharply, but criticisms of these later increases have been far more restrained than the attacks on depression expenditures.

CAUSES OF INCREASES IN PUBLIC EXPENDITURES

Increase in Population.—Among the more obvious causes of larger public expenditures in this country is the steady increase in the number of persons for whom governmental services must be performed. This growth in population, even if it called for nothing more than a duplication of existing governmental machinery, would bring about at least a proportional expansion in expenditures, unless it were found possible to render governmental services on the basis of mass production, with a decreasing cost per individual served. Unfortunately for our hopes in this direction, the performance of functions by the various governmental organizations seems to be subject to a law of increasing rather than decreasing costs; that is, an increase in the number of individuals cared for often involves a greater than proportional increase in the cost of rendering the services in question.

Not only does the performance of a given number of functions for an increasing number of persons bring with it an increase in the costs of government, both absolutely and per capita, but in addition it often happens that a growth in population causes an expansion of the needs which it appears necessary or wise to satisfy collectively rather than

⁵ *Chicago Tribune*, March 26, 1941.

individually. A growth in the population of a city, for example, usually brings about an expansion in the number of functions to be performed by (say) the police department, and does not mean simply that the same functions will be performed as before, though for a larger number of persons. This explains why the financial statistics of cities show a fairly steady per capita increase in public expenditures, as we pass from the smallest cities to the largest.

Changes in General Prices.—Changes in the general price level and the purchasing power of money constitute another cause of the growth of public expenditures. The general price level in the United States was slightly higher in 1913 than in 1903, and was much higher in 1928 than in either of these two other years. The price level in 1941 was lower than in 1928, but higher than in the other years mentioned. The national, state, and local governments, in order to render the services expected of them, must be able to obtain materials and supplies, and in general to gain access to the factors of production much as does any business man. The governments, in other words, must enter into competition with private individuals and corporations for the use of the necessary agents of production. Hence, when the prices of goods and productive factors rise, governmental expenditures must increase also, even though there is no change in the number of functions performed, or in the intensity with which they are carried on. Part of the increase in public expenditures since the turn of the century has been nominal rather than real, representing, it is true, the handling of more dollars, but not the expenditure of greater purchasing power. However, after making all allowances for changes in the purchasing power of money, there still remains a very large growth in public expenditures to account for.

Inefficiency in the Appropriation of Public Funds.—A factor which ranks high in the popular mind as a cause of increasing public expenditures is carelessness and extravagance in making appropriations for various purposes, combined with a lack of business methods, if not downright corruption, in the administration of public funds. Actually these evils can scarcely be an important cause of increasing public expenditures unless they themselves tend to increase in severity through time, but they may be an ever-present reason why public expenditures are greater than they need to be in view of the functions performed by governments.

The appropriation of funds with which to carry on the functions of the various governmental units in the United States is in the hands of elected representatives, that is, members of national and state legislatures and of city councils. Under our political system it often happens that the qualities which make it possible for a man to be elected to such an office are not those which will make him an expert in administering the duties devolving upon him. Public expenditures are determined, as a result, largely by men who lack training in economic principles and an under-

standing of economic problems. As a consequence, appropriations are often made in a haphazard and piecemeal fashion, some being entirely too small and more being disproportionately large, with each individual appropriation quite unrelated to any sum which might be regarded as an appropriate total.

Some improvement in this situation has taken place in recent years, since many of the governmental units, including the federal government itself, have adopted budget systems. A budget does afford some check upon appropriations, and it fixes to a certain extent the responsibility for them. However, it seems evident with each passing Congress that the evils mentioned above have not been completely eradicated. Indeed, it is likely that they cannot be eliminated until some change takes place in the attitude of large numbers of citizens toward the appropriation and expenditure of public funds.

The Popular Attitude Toward "Public Money."—The democratic form of government assumes that most voters will be intelligent and socially minded; that is, that they will know how best to serve their own interests and those of others, and that they will be sufficiently unselfish to take into consideration the broad social interests rather than their own personal gain. One is tempted to doubt that this assumption is well founded, especially when one observes the attitude of some persons toward the funds of the federal government. Many people seem to regard the federal treasury as a vast reservoir into which flow mysterious but inexhaustible streams of wealth. It appears to such people that the problem in connection with the treasury is not one of economy in appropriations and expenditure, but rather that of seeing to it that their particular district or locality receives its full share of the funds—or more than its share, if possible. Representatives in the national legislature are conceived of by their constituents as agents of their district, whose duty it is to insist that an appropriate portion of governmental funds shall be diverted in its particular direction. Representatives are instructed to "bring home the money or don't come back."

The only way a representative is likely to be able to get through, for his district, an item in the appropriation bill is by enlisting the support of other members by promising to vote for the favorite projects of these members, or, in other words, by engaging in what is commonly called "logrolling" or "back-scratching." Examples of this practice are to be found in the river and harbor bills, the public buildings bills, the army and navy bills, and in most of our recent tariff bills. Scrambles for federal funds have been apparent in connection with the public works and relief programs of the Roosevelt administration. It may be noted, also, that those who complain loudly about federal extravagance and waste often grab vigorously at whatever federal funds are to be had.

The probability of obtaining scientific and economical appropriations and expenditures in the face of such processes and attitudes is small.

Wastes in the Administration of Public Funds.—In the administration of governmental funds, as well as in the appropriation of such funds, undesirable practices may be noted. It is difficult to obtain proper administration of offices and funds, even given the best of efforts and intentions, when the holding of such offices is dependent upon the vagaries of political fortune. It is true that under our Civil Service Laws we have some slight modification of the old-fashioned "spoils system," under which appointments to government positions were generally regarded as a legitimate part of the fruits of victory at the polls; but there is still a high rate of "turnover" in offices which must be characterized by security of tenure if efficiency is to prevail. Certainly, the folly of electing by popular vote officials who are to hold positions requiring technical knowledge and training should be apparent to everyone.

Though there are many public officials in the employ of the various governmental units who serve faithfully and well for modest salaries, it must be admitted that there are others who expend public funds in a wasteful and extravagant manner. This waste may take a variety of forms. In some cases the payrolls are padded—that is, more persons are employed than are needed to carry on the functions of government, and members of an administrator's family are often placed in appointive positions. Sometimes the quantities of supplies and equipment purchased are unnecessarily large, or the prices paid are unreasonably high in view of the quality obtained. Again, contracts may be awarded to those who have not submitted the most favorable bid for the work in question. We do not mean, of course, that only in governmental hands are funds wastefully expended, for much waste occurs also in private business expenditures.

The Expansion of Governmental Functions.—But after due allowance has been made for growth in population, changes in the price level, and other matters, there still remains a large increase in public expenditures to be accounted for. An explanation can be made largely in terms of the continually growing number of functions being performed by federal, state, and local governments. This expansion of functions in turn has been largely the outcome of two closely related and interwoven factors—the great and pressing economic problems which have developed as our economic system increased in size and complexity, and a growing conviction that social welfare can and should be advanced by collective action through the government.

Economic Problems and Public Expenditures.—With the development of our economic system, production has become highly specialized, roundabout, and large scale. The economy has become increasingly de-

pendent upon a smoothly functioning system of exchange, and economic interdependence has increased greatly. As the economic system became larger and more complex, problems developed which seemed to call for collective action. Their number is legion, and would include problems of money and banking, of public utilities, of monopolies, of agriculture, of international trade, of economic insecurity, and of labor relations. The attempts to deal with these problems are described in other chapters. At this point, we merely note that many of the problems cause distress to large numbers of people and demand governmental attention. In many cases the solutions have been governmental regulation, which has not involved large public expenditures though it has added greatly to the list of governmental functions.

Other Increases in Governmental Functions.—But the functions of government have increased for other reasons as well. State and local governments spend large sums for highways and education. These expenditures make for the continued development of our people and their economic activities, and hence for the general welfare.

When the automobile was first introduced, highway construction and maintenance could be provided at a cost which would now seem remarkably low. However, the use of the automobile for pleasure has increased so rapidly that a car is at present regarded by most families as a necessity, while its use for commercial purposes has grown almost as rapidly. Traffic on the main highways has become extremely heavy, and the expense of constructing and maintaining macadam and concrete surfaces which will support giant motor trucks is very high.

As an economic system increases in complexity, it becomes more and more apparent that adequate preparation for one's life work is essential to the achievement of a high measure of success, and it becomes extremely difficult for a person to rise from the ranks if he depends upon his native ability unaided by occupational training. Also, as standards of living improve, greater educational facilities are demanded and obtained. For these and other reasons, we are at present attempting by collective action to provide everyone with a certain minimum amount of training, and to assist as many as possible to pursue higher education. Since little or no effort is made to place most of our educational activities on a self-supporting basis, the cost in the form of public expenditures is large.

There have been other large increases for hospitals, clinics, health and sanitation, recreation, and institutions for delinquents, dependents, and defectives. In the dreary days when the insane were left to "mumble in the chimney corner," when the feeble-minded were allowed to roam at will and were merely regarded as a bit queer, when sickness or even plagues were thought to be marks of divine disfavor or of evil spirits rather than results of lack of sanitation, and each family was expected

to pay for its own medical attention or to go without, governmental expenditures for such purposes were not large. But nowadays we regard the satisfactory handling of these matters as vital to the public welfare, and undertake to provide for them through governmental agencies. Provision of this kind is praiseworthy, but it is also expensive.

Governmental Expenditures in Depression.—The relationship between economic problems and governmental expenditures is clearly seen in the expansion of governmental functions in the depression years following 1929. The United States had many business depressions prior to 1929, but the earlier depressions had been allowed to run their course, apparently on the principle that recovery attained in the "natural" manner would be prompt and lasting. But in the post-1929 depression there was a widespread demand that the government take action both to promote recovery from the depression and to relieve the millions of unemployed and destitute. The response of government to this demand resulted in greatly expanded functions and enormous public expenditures.

The Provision of Relief for the Unemployed.—One important depression activity was caring for the unemployed, numbering over 12 million persons at the worst of the depression. Most of these people, if unassisted, would have been not only unemployed but completely destitute, lacking even those minimum resources necessary to keep body and soul together. With state and local governments apparently unable to handle the problem, the federal government lent a helping hand. Its activities in behalf of the unemployed, through the Public Works Administration, the Civil Works Administration, the Civilian Conservation Corps, the Work Projects Administration, and assistance given the states in providing direct relief, have been very costly. From 1933 to 1941, inclusive, the total expenditures for unemployment relief were about \$18,000,000,000, or \$26,000,000,000 if public works are included as a part of unemployment relief.⁶

Assistance to Agriculture.—American agriculture was in a critical condition following the first World War, and suffered still further losses during the depression. The agricultural problem and its treatment by the government will be examined in Chapters 45 and 46, but we may note here that the condition of agriculture during the depression was so serious as to constitute a severe drag on general recovery, in addition to being a difficult problem in itself. The federal government, through the Agricultural Adjustment Administration, the Farm Credit Administration, the Commodity Credit Corporation, and other agencies, attempted to regulate agricultural production, raise the prices of farm products, refinance farm mortgages, and lend the farmers credit on their holdings of various crops. The expenditures for these purposes have been more than a bil-

⁶ *Chicago Tribune*, January 9, 1941; and a press release of the United States Treasury Department, July 2, 1941.

lion dollars in certain years, and totaled over \$5,000,000,000 for the period from 1933 to 1941, inclusive.⁹

Other Depression Activities.—Another project that involved hundreds of millions of dollars was the Reconstruction Finance Corporation, which was designed to render financial assistance to railroads, banks, and other institutions. The federal government attempted to refinance the obligations of home owners other than farmers. It also contributed \$150,000,000 to the Federal Deposit Insurance Corporation, which was organized to give security to bank depositors. Other depression activities of the federal government, which in most cases cost less than those already mentioned but formed important parts of the government's program, included the National Recovery Administration, which was intended to assist in the rehabilitation of industry and business through self-regulation; the regulation of the issue of new securities and of the activities of security exchanges through the Securities and Exchange Commission under laws of 1933 and 1934; the regulation of the public utility industry through the Securities and Exchange Commission and the Federal Power Commission under the Wheeler-Rayburn Law of 1935; the Tennessee Valley Authority; the Subsistence Homesteads Projects; the Emergency Housing Program; and the activities of the Federal Communications Commission, the Federal Alcohol Control Board, and the National Labor Relations Board. The administration of the Social Security Act through the Social Security Board has become a very expensive project. The monetary and banking activities of the government resulting from the depression have thus far been conducted at a net profit.

Though the above list of activities recently carried on by the federal government is not complete, we have mentioned enough items to indicate the great increase that has taken place in the number of functions performed by the federal government and, incidentally, in the number of federal employees. It will be noted that we have not as yet attempted to evaluate or criticize the activities of the federal government, for we must first set up a criterion of the proper activities of government in general.

PROPER ACTIVITIES OF GOVERNMENT

Our discussion has shown us that, except for allowances that must be made for such factors as changes in general prices, and extravagance and graft, the size of public expenditures depends upon the number and cost of the services which the various governmental units are called upon to render. Hence, in connection with the study of public expenditures, it is important to inquire how many functions should be assigned to the government. Since many of the functions now performed collectively could

⁹ *Chicago Tribune*, January 9, 1941; and a press release of the United States Treasury Department, July 2, 1941.

be derived in the aggregate from the new services rendered is in excess of the amount lost in the aggregate by having to give over the funds in question to the government.

This principle should be modified to allow for the fact that a direct comparison of satisfactions is not always the one to be made. Funds may be spent and hence have to be collected in such amounts and such ways as will indirectly have the rather serious effect of restraining or depressing business. For this reason the principle should be stated as follows: A government should collect and spend such an aggregate sum that the advantage in the form of satisfaction to be gained by any further collections and expenditures will not be sufficient to offset the disadvantage of loss of satisfaction, either direct, or indirect through the ill effects on business, by reason of turning the funds in question over to the government. Furthermore, just as an individual attempts to distribute his income among the various objects of expenditure in such a way as to make the last dollar spent for each purpose afford him as much satisfaction as could be derived from a like expenditure for any other object, so too it might be desirable to have the aggregate amount of expenditure of the government split up among the several governmental activities in such manner that no money will be spent for one purpose which would result in greater satisfaction if it were added to the sum to be spent for some other purpose.

Difficulties in the Use of This Test.—It must be admitted that this test for public expenditures has its disadvantages. It has often been said that satisfaction is a matter which each individual must decide for himself, and which as a consequence cannot be accurately measured by some individuals for others. And yet, in applying this test for governmental activities and expenditures, it will be necessary for us constantly to form an opinion as to whether the satisfaction to be gained from a service to be rendered by the government will or will not exceed the loss of satisfaction, direct or indirect, suffered by the various contributors supporting the government by turning over the necessary funds in the form of taxes. In addition, the application of the test will require an accuracy of estimate and a nicety of judgment which are not always possessed by those who make decisions on questions of governmental activities and expenditures. In spite of these objections, it seems that the considerations set forth in the preceding paragraph are those which should be borne in mind in reaching such decisions.

Inequalities of Wealth and Income and Governmental Expenditures.—Further conclusions of some importance may be reached by a consideration of the test for public expenditures. The sum total of public expenditures, according to this test, will tend to be greatest in countries where there are great inequalities of wealth and incomes. This is particularly true if a system of progressive taxation is employed to collect

sons that, *under ordinary circumstances and from the strictly economic point of view*, war is an unwise and costly method of "settling" disputes between nations. Modern wars almost inevitably bring economic losses, and not economic gains, to all the participating nations.

If the test of satisfaction is applied to this type of expenditure, there seems to be only one way in which the test may be stretched sufficiently to make it cover the activity. If the conditions of the world today are regarded as fixed, unyielding conditions to which we may react but which we cannot change, then preparation for war, and at times the actual waging of war, may be necessary. We do not want aggressor nations to be in a position to take our land and resources from us, or to destroy our institutions. To prevent such heavy losses, it may be worth while for us to bear the burdens involved in preparing for and waging war. Thus, war may be the lesser of two great evils, even if it results in severe economic losses. On the other hand, from the point of view of the world as a whole the billions of dollars spent for wars and armaments in the past and present have been and are economic waste. There would be a greater sum total of satisfaction from the use of economic goods if the world were freed from military conflict.

The Need for Our Depression Expenditures.—What shall we say of the depression activities of the federal government? Almost any of them may be readily attacked from the individual point of view. That is, a person may condemn those activities which have raised or will raise his taxes and yet confer no direct benefits on him. From a social point of view, however, it is difficult to condemn many of these activities outright. The largest, and most severely criticized, depression expenditure has been for the maintenance of various governmental activities to provide work or relief for the unemployed and destitute. In so far as governmental assistance was received by those who really needed it, it is hard to believe that these expenditures did not give more satisfaction to the recipients of the government's aid than they took away, or will take away, from the taxpayers. However great the pangs suffered by those who have paid or must pay taxes to cover relief expenditures, they are doubtless less painful than the pangs of death by starvation or exposure.

Most criticisms of relief expenditures are probably partly justified. The administration may not have adopted the best methods of caring for the unemployed, and there has undoubtedly been some waste and graft in the administration of relief. It is probable that many workers on P.W.A. projects have some private employment as well, and that relief funds have been used in some cases toward political ends. The receipt of governmental assistance has undoubtedly weakened the morale of some persons and made them anxious to make a "career" of the W.P.A. or to retire on relief, rather than to shift for themselves in private employment. But after all is said and done, these facts seem to be well established: (1) Large ex-

and its debt has been mounting rapidly. It reached \$40,440,000,000 in 1939, after nine years of deficit financing of depression activities.⁸ In 1940 and 1941, with heavy national defense expenditures added to an already unbalanced budget, the debt grew to \$48,961,000,000, as is shown in Table 51. Estimates for 1942 called for total expenditures of \$22,169,000,000 (including \$15,500,000,000 for national defense), revenues of \$12,500,000,000, and a national debt of about \$58,000,000,000.⁹

TABLE 51.—EXPENDITURES, REVENUES, DEFICITS, AND PUBLIC DEBT OF THE FEDERAL GOVERNMENT, 1931-42

(Sources: Daily Statement of the United States Treasury, June 30, 1911, and the *Chicago Tribune*, January 9, 1941, and July 3, 1941)

Year	Expenditures (Exclusive of Debt Retirement)	Revenues (Ex- clusive of Social Security Funds)	Deficits	Public Debt
1931	\$ 3,652,000,000	\$ 3,190,000,000	\$ 462,000,000	\$16,801,000,000
1932	4,535,000,000	2,006,000,000	2,529,000,000	19,487,000,000
1933	3,864,000,000	2,080,000,000	1,784,000,000	22,539,000,000
1934	6,011,000,000	3,116,000,000	2,895,000,000	27,053,000,000
1935	7,010,000,000	3,800,000,000	3,210,000,000	28,701,000,000
1936	8,666,000,000	4,116,000,000	4,550,000,000	33,778,000,000
1937	8,177,000,000	5,020,000,000	3,148,000,000	36,425,000,000
1938	7,230,000,000	5,855,000,000	1,384,000,000	37,165,000,000
1939	8,707,000,000	5,165,000,000	3,542,000,000	40,440,000,000
1940	8,998,000,000	5,387,000,000	3,611,000,000	42,968,000,000
1941	12,710,000,000	7,607,000,000	5,103,000,000	48,961,000,000
1942 (Est.)	22,169,000,000	12,500,000,000	9,669,000,000	58,000,000,000

Danger in the Public Debt Situation.—There can be no sound objection to governmental borrowing to meet an emergency, when revenues fall short; but it is sometimes said that continuing deficits of several billion dollars a year are likely to lead to the destruction of the government's credit. If the public debt grows so large that full payment of interest and repayment of principal become improbable, the government may be unable to continue borrowing from its citizens. If it is then unable or unwilling to decrease expenditures or increase ordinary revenues, it may be forced to print paper money with which to pay its bills. These inflationary tactics on the part of a government usually lead to an economic breakdown from which a country may not completely recover for a generation or more. It is held, moreover, that even if the situation does not lead to fiscal disaster, the government will pass on to coming generations a crushing burden of debt to be paid in the future.

The dangers of an unbalanced budget are often exaggerated through likening the government to a private individual. If an individual per-

⁸ *Chicago Tribune*, January 9, 1941.

⁹ *Ibid.*, July 3, 1941.

sistently spends more money than he takes in, it is clear that he will come to financial grief, but the problem of the individual is to adjust his expenditures to his income, while that of the government is the reverse. That is, the government habitually decides upon the functions it should perform, and then undertakes to collect enough revenue to carry on these functions. While it is true that, in the long run, persistently large deficits might destroy the government's credit and lead to an orgy of inflation, this does not mean that a national budget must be balanced every year, or in short periods of a few years each. If a national emergency requires expenditures in excess of collectible revenues, a government would be foolish not to permit its budget to become unbalanced. When a man needs a surgical operation, he does not hesitate to call in the surgeon merely because the cost would unbalance his budget for that year.

Perhaps the sanest attitude to adopt is that the national budget, in peace times, should balance *over an entire business cycle*. In periods of depression, the governmental expenditures are likely to increase, while revenues fall off sharply in spite of all that can be done. Hence, in good business years, the government should collect more revenue than is necessary to carry on its current functions so that a reserve may be built up against the next depression. Wars, on the other hand, are today so very costly that the government has no alternative to a rapid increase in the public debt, and it is most unlikely that modern war debts can be paid off in the intervals between these international disturbances.

While the federal debt of \$48,961,000,000 in 1941 was the largest in our history and amounted to \$368.74 per capita, the British public debt was more than \$700 per capita as long ago as 1935, while that of France was about \$525 per capita.¹⁰ The debts of both England and France increased greatly after the beginning of war in 1939. Moreover, in view of our vastly greater per capita wealth and resources, it is probable that we could support a much larger per capita debt burden than either of these countries. Our national debt is now only about 15 per cent of the pre-depression value of the wealth of the United States, and the interest payments on this debt absorbed between one and two per cent of our national income in 1941. The government's securities continue to find a ready market, and at very modest interest rates. Even those who "viewed with alarm" the \$25,000,000,000 increase in our national debt during the post-1929 depression seem almost to "point with pride" to the far greater increase necessitated, first, by expenditures for national defense, and later for prosecuting an "all out" war against Germany, Italy, and Japan. All in all, there is no justification for saying, as some people do, that federal finances stand on the edge of an abyss, and that almost any day may witness the government's acknowledgment of bankruptcy.

¹⁰ *New York Times*, December 13, 1935.

The Burden on Future Generations.—Another complaint about our public debt is to the effect that we are arranging to pass on to our children and grandchildren a staggering burden of debt which they will have to pay, to their own great detriment. Though this argument has very little of actual economic significance, it is nevertheless rather popular and demands some attention. Clearly, in the sense of *real income*, future generations can hardly suffer from a large public debt incurred now. When the government borrows to buy wheat to feed its starving citizens, the wheat is taken not from the crops of thirty or fifty years hence, but from present supplies. When cotton is plowed under with borrowed funds, it reduces the current crops, not those which our grandchildren will harvest. When the government spends billions of dollars for armaments, it causes a shortage of consumers' goods here and now, and not in the more or less indefinite future. What really happens when the government borrows is that our citizens are induced to turn over to it a part of their current money income. With these funds, the government is able to secure a larger share of our *present national real income* than it could otherwise obtain, and private individuals must get along with a smaller share than they would otherwise have. In the sense of real income, then, the cost of public borrowing is borne now in the form of a smaller real income for private purposes than would otherwise be available. Of course, when taxes are finally collected to pay off the debt, they may be so large in amount or collected in such ways as to hamper and restrain business and impair the effectiveness of our productive facilities, thus reducing real income in future years, but there is nothing about public borrowing which, in and of itself, leads to such a result.

But even if the size of the national real income in the future is not likely to be affected by present increases in the public debt, may it not at least be said that a *financial* burden is passed on to future generations? It is true, of course, that taxes must some day be collected if the government is to pay interest and principal on its obligations, but at the same time these amounts will be paid to the owners of the government bonds which represent our public debt. If the people who own the bonds also pay the taxes, even private individuals may "break even" on the process. But whether certain *individuals* gain, lose, or break even, it is clear that the *nation as a whole*, in paying off the public debt, merely transfers money from one pocket to another so long as the entire debt is held within the country. This transfer is not necessarily without significance, for the economic effects of the reinvestment of funds by bondholders may not be the same as would have followed the spending of identical sums by the taxpayers. Of course, bondholders may spend their funds (instead of investing) when the bonds are paid off, and taxpayers, on the other hand, might have invested the funds (instead of spending), if they had not had them taken away in the form of taxes. We come to the conclusion, then, that

we wish the government, instead of private enterprisers, to perform for us. And since we will pay the bill, we are entitled to make the number of such services great or small, as we see fit.

Efficiency in Government.—The nature and extent of the functions which the government is to perform having been decided, it is the part of wisdom for a people to insure that public expenditures shall not exceed those amounts which, with reasonable standards of efficiency, may be required to carry on these activities. Carelessness, inefficiency, and corruption should not be tolerated. To eliminate such evils, many writers on public finance recommend a reform of the budgetary mechanism to obtain a closer adjustment of appropriations to needs and to fix responsibility, changes in the Civil Service Laws to bring a more efficient system of governmental employment, provision of security of tenure and more adequate salaries in order to attract higher types of employees into the government service, and, in general, the introduction of sound business methods into the operation of governmental affairs.

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1. Why is it desirable to have certain services provided by governments rather than by private agencies?
 2. In what way is the problem of public expenditures related to the performance of these functions by governments?
 3. What has been the trend in recent years in the volume of expenditures made by the federal government? Explain the nature of the principal items of expenditure.
 4. What has been the recent trend in the volume of expenditures made by state and local governments in the United States?
 5. Compare the chief functions and expenditures of the federal government with those of state and local governments.
 6. What relationship exists between the growth of population and the growth of public expenditures? Explain.
 7. "A part of the increase in public expenditures in the United States in the twentieth century has been nominal, rather than real." What is the significance of this statement?
 8. How does inefficiency in the appropriation and administration of public funds affect the total of public expenditures?
 9. What is meant by "the popular attitude toward public money"?
 10. How have economic and social changes been responsible for a part of the increase in governmental functions and expenditures?
 11. What has been the influence of the growing spirit of humanitarianism upon governmental functions and expenditures? Why?
 12. How did the great depression following 1929 affect governmental functions and expenditures? Explain.
 13. "The problem in connection with public expenditures is to decide how large a part of our real incomes we wish to receive collectively rather than individually." What is the significance of this statement in setting up a criterion for public expenditures? Explain.
 14. It is said that a certain large eastern city pays the sum of \$100,000 yearly for the storage of its voting machines during periods when they are not in

- use. Comment upon this governmental expenditure in the light of the test for public expenditures proposed in this chapter.
15. In the light of the proposed test for public expenditures, how would you criticize the major items of expenditure of the various governmental units in this country in the past?
 16. If, as some writers suggest, it is no less incorrect *economically* to speak of "winning a war" than to talk about "winning an earthquake," why is it that we spend so large a part of our national income for submarines, battle-ships; and bombing planes?
 17. Comment on the necessity for the principal depression expenditures of our national government in recent years, in the light of the suggested test for public expenditures.
 18. Describe the growth of the national debt in recent years.
 19. What danger is involved in operating the federal government at a deficit? Explain.
 20. Is it necessary that the national budget shall balance every year? Explain.
 21. Have recent increases in the national debt endangered the credit of our federal government? Why?
 22. Does public borrowing shift the *financial* burden of public expenditures to future generations? Explain.
 23. Does it shift the *real* burden to future generations? Explain.
 24. Why is there need for a changed public attitude toward public expenditures?
 25. How should we seek efficiency in the conduct of government?

REFERENCES FOR FURTHER READING

See list of references at the end of Chapter 44.

TAXATION

ONCE it has been decided what functions shall be performed by governmental agencies, there remains the task of determining the method or methods of procuring the funds from which the proposed public expenditures may be made. At times the national governments have deemed it wise to manufacture their own purchasing power. In other words, they have printed large issues of inconvertible or "fiat" money which they have used in paying for the governmental functions. The effect of this additional purchasing power, competing with the money already in circulation for the existing supplies of commodities and services, has been to deprive the individual citizens of a part of their purchasing power just as effectively as if the governments had exacted tribute from these citizens in the first place.

As we noted in the preceding chapter, governments have commonly borrowed to obtain funds for public expenditures. This method has been used whenever it has appeared undesirable or impossible to obtain sufficient funds for current expenditures from current sources of revenue. By borrowing, we get government services in the present and pay for them on the installment plan over a long period of years. Occasionally certain units of government secure small amounts of revenue from the conduct of various public service enterprises, but this is not ordinarily an important source of public income.

The Nature of Taxation.—The most important source of the funds from which public expenditures are made has been and will doubtless continue to be taxation. A tax is "a compulsory contribution from the person to the government to defray the expenses incurred in the common interest of all, without reference to special benefits conferred."¹ In connection with this definition several observations should be made. First, a tax is a compulsory contribution in that the amount to be paid is decided by the government, as are also the time and method of payment, without regard for the wishes of the individual taxpayer. In the second place, there is in taxation no definite *quid pro quo*; that is, the taxpayers are required to contribute to the support of the government on some basis other than the

¹E. R. A. Seligman, *Essays in Taxation*, New York, The Macmillan Company, 9th ed., 1921, p. 432.

amount of benefit or service directly received by them from the government. It often happens that the persons called upon to pay the largest taxes are those who are least dependent on governmental services and who could best provide for themselves if the services in question were not performed by the government. Finally, the purpose of a tax is to provide revenue for carrying on various functions in the interest of the public. In this connection a serious question often arises as to whether a tax may properly be made the instrument for the accomplishment of some ulterior purpose, such as the reduction of existing inequalities of wealth and income.

The Problem of Taxation.—Since all governmental units of the present day find it imperative to obtain the greater portion of their revenues from taxation, the problem of taxation becomes one of securing these necessary revenues in such manner as will, among other things, involve the smallest possible expense in collection and administration, interfere as little as possible with the conduct of business and economic progress, and distribute the burden of supporting the government in as equitable a manner as possible.

GENERAL PRINCIPLES OF TAXATION

Fiscal Adequacy.—Since the purpose of taxation is to provide large amounts of revenue for the different units of government, the first and most important test of a tax system is whether it will furnish sufficient revenue. The satisfaction of this test alone does not insure a perfect system of taxation, for many other important considerations must be borne in mind; but the inability to meet this test is of itself quite enough to make a tax system a failure. It matters little how convenient, economical, or simple the system is, or how well it succeeds in distributing the tax burden according to the high principles of equity and justice, if it does not provide the necessary revenue for the performance of the functions of government. Indeed, in times of great emergency—such, for example, as when a war is being waged—other factors are disregarded and the sole consideration of the government in passing upon tax rates and methods becomes that of fiscal adequacy.

Economy.—As has been said, a tax system is set up in order to obtain a certain amount of revenue which is necessary for the performance of governmental functions. A sum must be collected from the taxpayers, however, which is larger than the amount to be spent by the government in question, in order to cover the costs of collecting and administering the taxes. Other things being equal, taxes which involve the collection of large increments of revenue, with a minimum of complaints and book-keeping details to be handled, are preferable to those which necessitate the collection of a multitude of small sums and involve great complexity of administrative machinery. In the words of Adam Smith, "Every tax

ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the state."

However, in connection with the test of economy, as well as with that of fiscal adequacy, the effects of taxation on the taxpayer and upon business in general must be considered. No tax is fiscally adequate, however great the revenue which it produces, and no tax is economical, however small its cost of collection and administration, if it is levied in such fashion or to such extent as to discourage business activity, curb individual initiative, or check unduly the accumulation of capital. It would be possible to devise a very simple system of taxation, the burden of which would rest entirely upon large incomes and large accumulations of wealth; but while this system might be a marvel of adequacy and economy for a time, its long-run results might easily be disastrous because of its effects on capital accumulation and business initiative. Almost everyone admits the validity of this principle, but there are great differences of opinion as to the exact point at which these undesirable effects would show themselves if higher and yet higher taxes were assessed on large incomes and great stores of wealth. It is probable that this point has never, as yet, been reached in actual practice in this country.

Simplicity, Certainty, and Convenience.—Simplicity is another desirable feature of a tax system. The provisions of our tax laws should not be complicated, but should be so worded that they may readily be understood by those who must pay the taxes as well as those who administer the tax laws. It is scarcely likely that any system of taxation could be set up which would be understood in all its ramifications by all of the taxpayers and officials concerned, but it is certain that our present laws leave room for a large measure of progress in the direction of simplification.

A sound tax system will also be characterized by certainty. It is probable that our economic system could in the long run become adjusted to either a high or low level of taxation with something like equal success, but uncertainty seems ever to be productive of undesirable results. Witness, for example, the effect of uncertainty as to the provisions of an impending tariff bill upon business activity in the United States! Uncertainty in taxation also provides many opportunities for chicanery and corruption in the assessment and collection of taxes.

Taxes should be collected at such times and in such a manner as will be most convenient for the taxpayers. It is not possible, of course, to have all taxes marked by convenience of payment, but we retain some taxes, such as those on commodities, which are very convenient to pay though they fall far short of perfection with regard to some of our other tests. In general, convenience of payment is a desirable quality whenever it can be obtained.

Elasticity.—Writers on the subject of money and banking are in general agreement that one of the principal defects of our money and credit system prior to 1913 was its inelasticity. The quantity of money and credit could not be enlarged sufficiently to meet the emergency needs of business, and recurrent periods of monetary stringency and even financial panics resulted. Inelasticity is a serious defect in a system of taxation, also, for it means that the revenue received from the taxes in operation cannot be expanded to meet the larger needs which may be experienced from time to time. Consequently, if the tax system lacks elasticity, there are likely to be frequent deficits and a dependence on borrowing to secure the funds with which to meet current obligations.

Equity.—A final requisite for a sound tax system is that it shall be equitable. Once it is ascertained that a given system of taxation is likely to provide an adequate amount of revenue, the next most important consideration is to have the tax burden distributed among the taxpayers in an equitable manner. This consideration becomes increasingly significant as the size of the aggregate volume of taxation increases. Years ago, when public expenditures were relatively slight and the total burden of taxation was not heavy, almost any system was likely to be reasonably fair. This would not be true at the present time. In view of the importance of the principle of equity, it will be well to inquire further into its meaning as applied to a system of taxation.

The Benefit Theory of Taxation.—Many persons have held in the past that a tax should not be defined as we have defined it, but should be considered a payment to the government because of, and in proportion to, benefits received from it. Thus a person who benefited greatly at the hands of the government would be expected to pay a large sum in taxes, while one who derived but slight satisfaction from services rendered by it would not be asked to give any considerable portion of his income to its support. However, though the benefit principle seems very just in theory, it has been largely abandoned because of the apparent impossibility of applying it in practice. In the first place, it is not possible to determine exactly how much benefit each citizen receives from the government. Here we are dealing with the matter of individual satisfactions, which cannot be accurately appraised except by each for himself. In the second place, even if benefits could be correctly estimated, we might find that the persons receiving the largest benefits from the services rendered by the different governmental units were the very ones who were least able to spare any great amount in taxes to pay the costs of such services. On the other hand, as we have already said, those with very large means might well be able to provide for themselves many services now rendered by the various governmental units. Thus they would be less dependent than the poor upon these services, and could not be called

upon to make any large contributions to the government on the basis of the benefit principle.

The Principle of Ability to Pay.—Most economists and writers on public finance at the present time have gone over to the principle of ability to pay, which holds that each individual should be taxed, for the most part, according to his ability to make contributions to the support of the state, without regard to the amount of benefit he may derive from the activities of the government. This principle seems on the surface to be admirably simple, but its interpretation is extremely difficult. What, for example, shall be the test of ability to pay? The answer to this question used to be that the possession of property was a clear indication of ability to pay taxes, and it was decided that any man who was fortunate enough to own great quantities of wealth should be required to contribute large amounts to the governmental treasuries. As time went on, economists came to suspect that some modification of this answer was necessary, for many individuals were receiving large incomes annually but were escaping the tax-gatherer altogether under the prevailing system of general property taxes.

Income as an Indicator of Ability to Pay Taxes.—It may be said that today the greatest emphasis is placed upon income as a test of ability to pay, although property is by no means completely disregarded in this connection. This does not mean, however, that it is necessary merely to discover the amount of a person's income in order to pass judgment on his ability to pay taxes. Many other matters must be borne in mind, such as whether the income in question is "earned" or is derived from investments, whether it contains any elements such as the return on diminishing assets, whether it represents any surplus over and above the returns necessary to induce the individual to continue to perform his services or lend his capital, and, finally, the length of time over which the income is received.

Proportion vs. Progression.—Probably the most important question in connection with the principle of ability to pay relates to the way this ability increases as income increases. In other words, as a man's net taxable income increases, does his ability to pay taxes increase exactly in proportion to this increase, or more or less slowly? If A has a net taxable income of \$10,000, while that of B is \$5000, is A able to pay exactly twice as much in taxes as B, more than twice as much, or less than twice as much, supposing the considerations mentioned in the preceding paragraph to be the same for both individuals? These are questions that can be answered only after a further examination of the meaning of the principle of ability to pay. If we decide that A's ability to pay is exactly twice as great as B's, then taxation should be proportional—that is, the same rate should apply to both individuals—and at this rate A's contribution will be double that of B. If A has less than twice the ability of B

on the part of that person. The adoption of this principle would mean that any aggregate amount of revenue would be secured with a minimum aggregate sacrifice or loss of satisfaction.

A third theory holds that the principle of ability to pay would be best served if the tax burden were distributed in accordance with the "net utility of income" to different persons.² By net utility of income is meant the margin between the total satisfaction obtained through spending one's money income and the total cost or sacrifice necessary to obtain this income. All of these theories dealing with the proper distribution of the tax burden would be difficult to apply in practice because they deal with such subjective matters as satisfaction and sacrifice, which are influenced by all the vagaries of temperament, tastes, and sensitiveness of individuals, and are extremely hard to estimate for large numbers of persons. However, all the theories here mentioned point to the use of *progressive* rather than *proportional* rates of taxation, whenever the former can be applied. The rates of taxation would be mildly progressive under the theory of equal sacrifice, more steeply progressive under the theory of net utility of income, and very steeply progressive under the theory of least aggregate sacrifice.

The Opposition to Progressive Taxation.—The foes of progressive taxation advance several arguments which they believe show its undesirability. In the first place, it is suggested that the diminishing satisfaction theory of income spending cannot be proved; that the accumulation of great means brings with it a host of new wants that clamor for satisfaction; that no test can be applied to numerous individuals to determine accurately the benefits derived from spending income or the sacrifice of giving up a portion of it; and that, so far as we can judge on the basis of behavior, a tax of a given rate hurts a man of great income just as much as it does a man of small income. It may be true that the theory of diminishing utility as applied to income is not susceptible of proof, but it is nevertheless logical to assume that successive installments of income over and above the minimum for subsistence will be applied to the satisfaction of progressively less urgent wants. There can be little doubt that, as old wants are more and more completely satisfied, new wants arise on which further income may easily be spent; but these new wants are much more likely merely to retard the rate of decline in the satisfaction derived from spending money income than to maintain this satisfaction unimpaired from increment to increment.

A second charge against progressive rates of taxation claims that the result of their application is to penalize most severely those individuals who are most productive in our economic system, thus checking individual initiative and enterprise. This argument does not apply to all large

² Advocated in H. W. Peck, *Taxation and Welfare*, New York, The Macmillan Company, 1925, pp. 243-262.

incomes that are hit by progressive rates, because many of the largest incomes are dependent chiefly upon the return received from investments made in the past and not upon payments for services rendered in the present. The question here is not whether individuals will continue to save and invest, but whether they will continue to seek to earn large incomes when these are taxable at progressive rates. It seems most reasonable to conclude that individual initiative will not be greatly impaired by progressive taxation, at least as applied in this country. Moreover, no individual has only his own ability to thank for the large income which he may receive for his services. Society itself plays a part in building up these large incomes, and progressive taxation aims merely to recover for society a portion of the surplus accruing to these men of large incomes, over and above that amount which is remuneration for services rendered. Individual initiative and enterprise will not be seriously checked so long as a portion of this surplus remains in the possession of these persons. It must be remembered, also, that the amount of total net income left to the individual after the payment of the tax increases with every increase in the total taxable income that he receives.

- A more serious argument, if a sound one, is to the effect that progressive taxation checks the accumulation of capital. It is said that we are chiefly dependent upon large incomes for the surplus from which comes our supply of capital. Progressive taxation tends to reduce the inequality of incomes and hence the supply of savings. Since economic progress is thought to be contingent upon the steady accumulation of capital, these large incomes are believed by some to be justified, even though many of them are unearned. It seems very doubtful, however, that progressive taxation interferes seriously with the accumulation of capital. It would be difficult to devise a system of accumulation which would be more wasteful than the present. Indeed, some economists today are of the opinion that waste comes about by reason of actual overaccumulation of capital and a failure to maintain the proper balance between saving and spending for consumers' goods. Again, it is true that capital formation often takes place when expenditures are made by governmental units quite as much as though the funds were left in private hands. Finally, we may add that much saving is done automatically and without sacrifice. Especially is this true of the savings of persons of great wealth and income, and those of large corporations. Most interest payments involve a considerable element of saver's surplus, or income in excess of that necessary to bring about saving. As a result, it seems unlikely that the progressive taxation of incomes interferes to any great extent with saving and the accumulation of capital.

Our general conclusion must remain, then, that a progressive system of taxation should be resorted to, if we wish the burden of taxation to be distributed according to the principle of ability to pay.

The Incidence of Taxation.—In deciding whether a particular tax system is equitable, it is of vital importance to know who ultimately bears the burden of the various taxes levied. It has long been customary to divide taxes into two classes, direct and indirect. *Direct taxes* are those which are collected at the outset from the persons upon whom it is intended that the burden shall fall, such as a tax on the rent of land. *Indirect taxes* are those collected from one group of individuals with the expectation that the burden will be shifted by them to a different group. The classification of taxes into direct and indirect groups has proved to be unfortunate. In some cases, we find so-called direct taxes being passed on, in part at least, to others than those from whom the tax was originally collected, while at other times so-called indirect taxes have not been shifted, but have remained a burden upon those who paid them in the first place. Wholly apart from any classification, however, the problem of the "incidence," or ultimate burden, of taxation is extremely important.

The study of the shifting and incidence of taxation is a branch of the study of value. To know whether a tax on a given commodity is likely to be shifted, it is necessary to ascertain whether the conditions of production and sale for that commodity make it possible for its price to be raised so as to pass the amount of the tax on to the consumers. If the tax in question is one which is levied on some factor of production, such as land or capital, it is necessary to make a similar investigation into the conditions which determine the price of this factor of production, in order to discover whether the tax can or cannot be shifted.

THE FEDERAL REVENUE SYSTEM

As may be seen in Table 52, the federal government had total tax revenues of \$5,691,000,000 in the fiscal year 1940, and \$7,761,000,000 in 1941. Of the total tax revenues in 1941, the personal income tax yielded 18.3 per cent; corporation taxes, 28.7 per cent; payroll taxes, 11.9 per cent; estate and gift taxes, 5.3 per cent; excise taxes, 30.8 per cent; and customs duties, 5.0 per cent. The federal government also received relatively small amounts of revenue from non-tax sources in each year. We shall now turn to an examination of these several types of taxes.

The Personal Income Tax.—The taxation of personal incomes was a productive source of revenue in 1941, although this tax has in some other years yielded an even larger share of the total federal revenue. In applying the tax, after the deduction from gross income of the necessary expenses of acquiring it, an exemption of \$800 was allowed a single person, and one of \$2000 for a married couple or head of a family, together with \$400 for each dependent. A credit of 10 per cent of the amount of one's *earned* income was also allowed. Taxable income (that is, income above the exemptions noted) was taxed at the flat rate of 4 per cent.

TABLE 52.—SOURCES OF FEDERAL TAX REVENUE, FISCAL YEARS 1940 AND 1941

Source of Revenue	1940 Amount Received (in millions)	1940 Per Cent of Total Tax Revenue	1941 Amount Received (in millions)	1941 Per Cent of Total Tax Revenue
Personal income tax.....	\$ 982	17.3	\$1418	18.3
Corporation income tax.....	1121	19.7	1852	23.9
Capital stock tax.....	133	2.3	167	2.2
Excess profits taxes.....	18	0.3	192	2.5
Unjust enrichment tax.....	9	0.2	9	0.1
Payroll taxes (unemployment, social security, and railroad retirement)	834	14.7	926	11.9
Estate tax.....	331	5.8	355	4.6
Gift tax.....	29	0.5	52	0.7
Excise taxes:				
Liquor taxes.....	624	11.0	820	10.6
Tobacco taxes.....	609	10.7	698	9.0
Other stamp taxes ^a	39	0.7	39	0.5
Manufacturers' excise taxes ^b	447	7.8	617	7.8
Miscellaneous taxes ^c	166	2.9	225	2.9
Customs duties.....	349	6.1	391	5.0
Total Tax Revenue ^d	\$5691	100.0	\$7761	100.0

^a Such as taxes on the issue and transfer of securities, playing cards, and the sale or transfer of silver bullion.

^b Includes taxes on lubricating oils, gasoline, tires and tubes, automobiles, trucks, motorcycles, automobile accessories and parts, electrical energy, radios, phonograph records, mechanical refrigerators, firearms and supplies, toilet preparations, and matches.

^c Includes taxes on the use of telephone, telegraph, radio, and cable facilities; the transportation of oil by pipe line; safe deposit boxes; admissions to theaters, sporting events, etc.; club dues and initiation fees; the processing of coconut and other oils; oleomargarine; narcotics; and other taxes.

^d Sources: Press release of the Treasury Department, Bureau of Internal Revenue, August 18, 1941; and letter from Treasury Department, Bureau of Customs, September 5, 1941.

Additional taxes, called surtaxes, which made the personal income tax progressive, began at 4 per cent on net taxable incomes of \$4000 to \$6000, and reached a maximum of 75 per cent upon portions of net taxable incomes which exceeded \$5,000,000 a year. Finally, after computing his income tax, each individual was required to pay an additional 10 per cent of the amount of his tax for purposes of national defense.³

Merits of the Personal Income Tax.—The personal income tax is quite generally considered to be a good tax. It falls directly on income, from which all taxes must come eventually, if sometimes indirectly; and income

³ The Revenue Act of 1941 lowered the exemption for single persons to \$750, and that for married couples or heads of families to \$1500. The normal tax was not changed, but the surtax was increased so that it began at 6 per cent on the first dollar of taxable income and attained a maximum of 77 per cent. The former 10 per cent defense tax was made permanent and was included in the new surtax rates.

is the most widely accepted indicator of ability to pay. The tax has usually yielded a very large revenue but, being based on realized income, the receipts are likely to decline sharply in times of business depression when the government needs especially large revenues. The personal income tax lends itself readily to progressive rates, which we have found to be essential to any logical interpretation of the principle of ability to pay. It is certain as to time and manner of payment, but it is only moderately satisfactory from the point of view of economy in collection. But not all the tests of a sound tax system need be satisfied by any one tax. A tax may be defective in a number of respects and yet have its deficiencies well compensated by other taxes, so that the system as a whole conforms to the requirements set up.

Defects of the Tax.—The personal income tax law is complicated, and a person of considerable income often needs legal advice in arriving at the amount of tax he must pay. The method of assessment is by the taxpayer's declaration of his income, supplemented by information of amounts paid in salary, interest, or other types of income, furnished by employers and others who make the payments. This method of assessment requires a high degree of administrative efficiency if the tax is not to be merely one on honesty and to lead to widespread evasion. For many years, the tax discriminated, in effect, between different persons since, among other things, the wages and salaries of state and municipal employees and the income on certain "tax-exempt" securities issued by governmental units were exempted from the tax. In 1940, this situation was partly cleared up, for wages and salaries of state and municipal employees were then made subject to the income tax.

A defect in past income tax laws was a provision permitting taxpayers to offset current income with capital losses—such, for example, as losses sustained by selling securities at prices lower than those paid for them. The result of this provision was that persons with large current incomes sometimes had to pay only small income taxes, or none at all, in years of depression when capital losses were severe. In recent years, the regulations relating to capital gains and losses have been much improved. The extent to which capital gains and losses are permitted to figure in income tax computation at present varies inversely with the length of time during which the assets in question have been held. Short-term capital losses may be used to offset only short-term capital gains, and not current income, although such short-term losses may be carried over to the following year to offset short-term gains.

It is difficult to define income for purposes of taxation, and our laws do little more in this respect than to enumerate various taxable and non-taxable items. Under the law, as now interpreted, some peculiar situations arise. For example, a farmer need not count as taxable income the food and shelter provided by his farm, but no similar privilege is accorded

those who must buy their food and shelter with money income. Similarly, a house owner who occupies his house need not count as taxable income the shelter he enjoys, but if he rents the house to another the rental that he receives is taxable. Clearly, there is room for improvement in the application of the income tax to different people.

The Incidence of the Income Tax.—In discussing the incidence of the income tax many writers try to view the tax as a whole, and come to the conclusion that a tax on incomes cannot be shifted. It is argued that there is nothing about an income tax that enables individuals or companies to raise the prices of the goods they are selling, or makes the personal services or the capital furnished by individuals command a higher return. Consequently, it is said, all efforts to pass income taxes on to others are doomed to failure. A sounder approach to the problem, however, is to break up the income tax into its component parts before proceeding with the analysis.

The Income Tax and Labor Incomes.—A part of the tax on personal incomes may be said in the first instance to fall on the return for labor or services rendered. It is generally admitted that a tax on the labor income from a single occupation will tend to be shifted. If, for example, a considerable tax were to be placed on the labor income of plumbers, but not on that of other workers, the wages in this occupation would tend to rise until they were about as high, after allowing for the tax, as before. The burden of the tax would tend to be distributed over all labor, because the only way in which the wages of plumbers can rise (assuming no increase in the demand for their services) is to reduce the number of plumbers. This means more persons available for other occupations, and consequently slightly lower wages all around than before. Whether the shifting works out well depends to a large extent upon the movement of labor out of the plumbing trade and into other occupations, and it is probable that the process would in any event require a considerable period of time.

The federal income tax, in so far as it is a tax on labor income, in one sense is, and in another is not, similar to the tax just discussed. To be sure, the tax is not applied to any particular occupations, and yet as a matter of fact it has usually fallen on very few. The income tax has been less democratic than many have supposed. Between two and three million persons in the United States have paid income taxes in most years. Not only has this been a small percentage of our income receivers, but the tax has effected the labor incomes of the more highly paid occupations only. Such a tax might be at least partly shifted in the long run, by fewer persons preparing for and entering the occupations affected. In 1940 and 1941, several million new names were added to the list of income tax payers. If the tax is to apply permanently to *most* labor incomes, there will be little prospect of shifting it.

The Income Tax and Interest on Capital.—The income tax is, to a certain extent, a levy upon the return paid for the use of capital. If a tax applied only to the income from capital invested in certain industries, there would be a tendency for capital, in so far as it is mobile, to leave these industries and flow to others not subject to the tax. In this way, the amount of capital in the industries that are taxed would decrease, and its rate of remuneration would rise until, with the tax deducted, the rate of interest was as high as the rate in other industries. The federal income tax, in so far as it falls upon the income from capital, does not discriminate but applies to all lines of industry. Hence, the shifting cannot come about in the manner just described. If a shift does occur, it will be because the tax on the income from all capital is sufficiently burdensome to discourage saving and check accumulation. In this event, the supply of capital decreases, its marginal productivity rises as compared with that of labor and land, and its remuneration increases until the rate of interest is so high that the burden of the tax is not borne by the owners of capital. However, it is not at all certain the tax will have this effect on saving and accumulation, for reasons given above.⁴

The Income Tax and the Rent of Land.—In part, economic rent may be the income which is taxed by the federal income taxation. To the extent that this is true, the tax will tend not to be shifted. The amount of rent paid for the use of land is fixed by the conditions of demand for and supply of land. There is nothing about a tax on rent that makes people willing to pay a greater sum for the use of the land, nor can such a tax have the effect of reducing the amount of land available. Since neither demand nor supply will be affected, it is clear that the rent of land cannot be increased for the purpose of passing on the tax burden to others. Some people find it clearer to regard rent as a surplus which capital and labor produce in combination with some land, over and above what these factors could produce if they were applied to marginal lands. A tax on rent could not have the effect of increasing this surplus, however, and consequently could not be shifted.

The Corporation Income Tax.—The corporation income tax produced 23.9 per cent of the total federal tax revenue in 1941. Under a combination of normal and national-defense tax rates, corporations paid a tax of 14.85 per cent on the first \$5000 of taxable net income, 16.5 per cent on the next \$15,000, 18.7 per cent on the next \$5000, and 24 per cent on all taxable net income in excess of \$25,000. The corporate income tax has usually been a good income producer although, like the personal income tax, its yield diminishes greatly in poor business years. This tax is not open to some of the objections urged against the personal income tax, though in the case of both it is difficult to decide what constitutes net

⁴ See pp. 270–272.

in some cases alter the conclusions to those "who love to turn economics into a playground for logical exercises."

The Capital Stock and Declared Value Excess Profits Taxes.—The capital stock tax produced 2.2 per cent, and two excess profits taxes yielded 2.5 per cent, of total federal tax revenue in 1941. The capital stock tax and one of the excess profits taxes, called the "declared value excess profits tax," have been paired as complementary taxes since 1933. In 1941, the rate of the capital stock tax was \$1.10 per \$1000 of the declared value of each corporation's capital stock. Having declared a total value for its capital stock, a corporation could earn 10 per cent on this value without paying anything in the way of a declared value excess profits tax. However, it had to pay 6 per cent on net earnings of 10 to 15 per cent, and 12 per cent on net income in excess of 15 per cent, on the total declared value of its capital stock.

The capital stock and declared value excess profits taxes were applied in combination in order to get around a serious problem in the application of excess profits taxes—the valuation of a corporation's assets. Such a valuation must be determined if the tax is to apply to earnings in excess of a certain percentage of the value of the corporation's properties; but the valuation of businesses by the government has proved to be slow, costly, and troublesome. Under this combination of taxes, a corporation may place any valuation it pleases on its capital stock. However, if it declares capital stock at a low figure, though it will pay a small capital stock tax, it will be required to pay a large excess profits tax if the business is successful and has net earnings which constitute a high percentage of its low declared value. On the other hand, if it declares an unusually high value for its stock to escape the excess profits tax, it must pay a high capital stock tax, regardless of whether its earnings are high or low. Corporations have been given several opportunities to change the declared value of their capital stock.

The Excess Profits Tax of 1940.—The other excess profits tax, applied in 1940, granted each corporation a flat exemption of \$5000 of income, plus a credit computed by either of two methods—net income or invested capital. By the net income method, the credit amounts to 95 per cent of the average net income of the corporation in the period 1936–39, plus 8 per cent of the net capital addition or minus 6 per cent of the net capital reduction in a given taxable year. By the invested capital method, the credit is 8 per cent of the corporation's invested capital for the taxable year; and half of the firm's borrowed capital may be included in its investment. After the deduction of the exemption and the credit, each corporation (unless specifically exempted by law) paid the excess profits tax on the remainder of its income. The rate of the tax varied from 25 per cent on the first \$20,000 above the exemption and credit, to 50 per cent on amounts over \$500,000 above the exemption and credit.

incomes under the personal income tax. It would seem that this could be done by requiring every individual to declare annually, as part of his personal income, his proportionate share in the earnings of any corporations in which he was a stockholder, regardless of whether these earnings were actually distributed to the stockholders. Corporate net earnings would thus be included in individual incomes, for purposes of income taxation, and opportunities to use the corporation as a device for evading personal income taxes and surtaxes would be eliminated. In this way, also, we should avoid the complexities and inequities of the present system of corporate taxes, and eliminate the troublesome question of whether a corporation has ability to pay taxes, apart from the ability of its stockholders.

Payroll Taxes.—In 1941, payroll taxes produced 11.9 per cent of the tax revenue of the federal government. These taxes are collected for the accumulation of reserves required under the Social Security and Railroad Retirement Acts. The taxes levied under the Social Security Act have been described in Chapters 25 and 26. Considering payroll taxes from the point of view of public finance, we suggest that those which fall on the employees operate as a crude sort of income tax, for all employees who come under the Act pay the same percentage of their wages. The taxes paid in the first instance by the employers will tend to be shifted to either the workers or the consumers, and will be regressive in operation. It would probably be better, from the point of view of equity, to support the various old age and unemployment projects out of general revenues, but the tax-consciousness promoted by payroll taxes may be desirable.

The Estate and Gift Taxes.—The combination of estate and gift taxes produced 5.3 per cent of the total federal tax revenue in 1941. The estate tax is applied to estates as a whole rather than to shares received by individual heirs. The first \$40,000 of an estate is exempt. The tax varies from 2 per cent on the first \$10,000 above the exemption, to 70 per cent on that part of an estate which is in excess of \$50,000,000. Credit is given against the federal estate tax for 80 per cent of any amount which is paid in taxes under state inheritance tax laws. The gift tax, which is necessary to prevent the evasion of the estate tax through transfers of wealth between living individuals, has rates which are three-fourths as great as the estate tax rates. The exemption from the gift tax is \$4000 in any one year, or a total exemption of \$40,000.

The estate and gift taxes can be relied upon to produce a fair amount of revenue, but they are not a good source of increased revenue if the increase must be made available suddenly. The estate tax unquestionably accords with the principle of ability to pay. Inherited wealth is purely a surplus return to the heir, and is entirely unearned by him. The greater the amount that society permits to be passed on through inheritance,

the greater is the share which society may legitimately claim from an estate. The incidence of the tax is clear. Its burden rests wholly upon the receivers of the estate and cannot be shifted. The tax is certain as to amount, and as to time and manner of payment.

Objections to Inheritance Taxes.—There are, however, at least two possible objections to the estate tax which the government should be careful to meet. In the first place, it is argued that, if the tax is too high, it will lessen the efficiency of business men and slow down the process of saving and capital formation. It is said that one of the strongest motives for working to acquire a large income, and for saving and accumulating a fortune, is the desire to provide adequately for one's dependents. If the inheritance tax is very high, some men might not seek to acquire large incomes, or might spend them for current enjoyment, and as a consequence the vital process of saving and capital formation would languish.

There is undoubtedly some truth in this contention. The desire to provide adequately for dependents is one reason why men work, save, and accumulate. However, there are many other motives operating in the same direction, such as the desire for luxurious living, the wish to provide for one's old age, and a yearning for prestige and power; so that capital formation probably would not cease even if inheritance were entirely eliminated. In any case, the present federal taxation of estates is not likely to have any detrimental effects upon our economic system, for \$40,000 may be passed on free of tax and estates of even \$100,000 or \$200,000 are not greatly reduced by the tax. Indeed, some authorities on taxation urge that the estate tax rates should be increased and the exemptions lowered, with particularly high taxes applied to properties which were inherited twice or oftener. It is urged, also, that gift tax rates in the lower brackets should be raised, so that they will no longer provide so attractive a means of evading the higher rates of the estate tax.

Another objection to an estate tax is its inconvenience in payment. Many estates are left largely in the form of real estate, factories, machinery, and securities, and not in cash. Unless the heirs have other large sources of income, they may have to liquidate the inherited properties to pay the tax and, at a forced sale, might have to sell at a considerable loss. In this way, an heir might lose 40 or 50 per cent of the value of an estate on which the estate tax was only 25 per cent. This objection is taken care of, to some extent, by granting a reasonable period of time within which to pay the tax, and by providing for the revaluation of an estate if its value has declined between the date of death of the decedent and the date on which the tax must be paid.

Excise Taxes.—In 1941, excise taxes of various kinds produced 30.8 per cent of the total tax revenue of the federal government. Excise taxes are taxes on economic goods. In some cases, producers are required to buy and affix stamps to the articles they make and sell. Again, the pro-

ducers may be required merely to pay the government a certain amount per unit of product produced and sold. Some of the taxes are specific, as for example a tax of (say) 5 cents per package of 20 cigarettes; while others are *ad valorem* taxes, such as a tax of 10 per cent on the factory price of automobiles.

The Incidence of Excise Taxes.—While excise taxes are usually collected from the producer in the first instance, their burden is borne in the end by the ultimate consumer when the taxed goods are made under competitive conditions. The tax is shifted through increases in the prices of the taxed articles, for excise taxes are costs of production to the producers of the goods and must be covered by price if production is to continue. However, the process of shifting is not the simple one of adding the taxes to the old prices. According to the Law of Demand, an attempt to raise the price of a taxed article will decrease the volume of sales. The extent to which an increased price will curb sales depends upon the elasticity or inelasticity of demand, but some decrease in sales is inevitable if the total demand for the good remains the same as before. A decreased volume of sales results in a decreased output of the good, and this change of output is likely to cause a change in the manufacturing costs of producing the good in the period of current production. Since the new manufacturing cost may be either higher or lower than before, depending upon whether the former output was greater than, equal to, or less than normal capacity, the price of the taxed article may increase by either more or less than the amount of the tax, in the process of shifting the tax to consumers. The effect upon price also depends to some extent upon whether the tax is specific or *ad valorem*.

Under conditions of monopoly, partial monopoly, or imperfect competition, the shifting of excise taxes is less certain than under competition. The monopolist or partial monopolist does not care who pays the excise taxes. His only concern is to set output and price at figures which will bring him the greatest possible total net revenue from the production and sale of his good. In some cases, his former output and price may have been so much more profitable than any other combination of output and price that he will be better off in terms of total net revenue to leave both unchanged and bear the tax himself, instead of attempting to shift it to consumers by raising price and reducing output. In other cases, a new combination of output and price would doubtless be more profitable than the old one, after the imposition of the tax, and as a consequence the monopolist would raise price and decrease output.

The Merits and Demerits of Excise Taxes.—In general, the burden of taxes on commodities and other economic goods, no matter where it is first placed, tends finally to fall as a whole or in large part upon the consumers. Because of this fact, these taxes, judged by themselves, do great violence to our principle of ability to pay. They are not progressive,

gencies. Unfortunately, almost half of the tax revenue of the federal government is now obtained through indirect taxes, whose burden tends to be shifted to the final consumer, or through other regressive or non-progressive taxes. Hence, about one-half of the federal tax revenue comes from taxes which do not conform well to the principle of ability to pay. Excise and other non-progressive taxes may be necessary in years of unusually heavy expenditures, but the goal should be to collect from income and estate taxes as large a part as possible of total federal revenue. The attainment of this goal would, of course, require that exemptions be lowered in connection with these progressive taxes.

STATE REVENUES

The states are less dependent than the federal government upon taxation for their income, for they frequently derive as little as three-fourths of their total revenue from taxation. Their other sources of revenue include special assessments; fines, forfeits, and escheats; subventions, donations, and assessments; interest, rents, and highway privileges; earnings of general departments; and earnings of public service enterprises. In Table 53 we present the sources of state tax revenue in 1940.

TABLE 53.—SOURCES OF STATE TAX REVENUE, 1939 AND 1940

(Source: *Chicago Tribune*, March 20, 1941)

Source of Revenue	1939 Amount Received (in millions)	1939 Per Cent of Total Tax Revenue	1940 Amount Received (in millions)	1940 Per Cent of Total Tax Revenue
Income taxes	\$ 334	8.6	\$ 358	8.6
General property taxes	259	6.6	265	6.4
Inheritance, estate, and gift taxes	113	2.9	118	2.8
Sales and use taxes	1489	38.3	1647	39.5
Payroll taxes (unemployment)	799	20.6	844	20.2
Business taxes	408	10.5	444	10.6
Motor vehicle licenses	364	9.4	388	9.3
Poll taxes	6	0.2	6	0.1
Other taxes	112	2.9	101	2.5
Total Tax Revenues	\$3884	100.0	\$4171	100.0

State Income Taxation.—Because of the great variations in tax laws from state to state and the limitations of space, it will not be possible to discuss in detail the tax provisions of the several states. It is necessary to limit the present discussion to general considerations with respect to the tax systems of the state governments and to the incidence of such taxes as are not already familiar from our previous analysis. Income taxes are used in about two-thirds of the states, and in most cases are not very

most of the sales tax laws require separate charging of the tax to retail purchasers, in order to promote the shifting of the tax to consumers and to make them conscious of the fact that they are paying it. The sales tax is costly to collect and not at all simple to administer.

Motor Vehicle and Business License Fees.—Motor vehicle license fees are an obvious item in state revenues. Most, if not all, states require the payment of a registration fee annually on all motor vehicles, while many collect additional fees for operators' licenses. The item called "business taxes" in Table 53 does include some genuine taxes, but it is made up to a large extent of *fees* collected in return for licenses to carry on certain businesses or to follow certain professions. For example, one must obtain a license and pay a fee to sell cigarettes, to operate a tavern, or to work as a barber. While these fees are not taxes in the strict sense of the term, they have about the same effect as taxes on consumption or taxes on the operation of businesses which are able to shift the burden to the consumers. About 20 per cent of state tax revenues in 1940 were derived from motor vehicle fees and from business taxes and fees.

Other State Taxes.—The payroll taxes collected by the states are essentially similar to those levied by the federal government. Poll taxes, though collected in 44 states, are quite negligible in so far as revenue is concerned. Their incidence is upon the individuals on whom they are levied. The poll tax is a tax of a flat amount for each person, and would be most inequitable if it were not for the fact that the amount is ordinarily very slight. In addition to the general types of taxes mentioned above, there are many others, peculiar to individual states or small groups of states, which yielded 2.5 per cent of state tax revenues in 1940.

State Tax Systems as a Whole.—The states, like the federal government, have had great difficulty in making ends meet under their present tax systems, and have become involved in borrowing operations. In 1940, as in other years, practically all of the state tax revenues were derived from taxes which do not conform to the principle of ability to pay. This means that the revenue systems of the states are highly regressive in operation, and that the burden of state taxation falls relatively more heavily upon the poor than upon the rich. The need for replacing sales taxes and other regressive taxes with income taxes and other progressive taxes is obvious.

LOCAL GOVERNMENT REVENUES

We shall use figures for the 94 largest cities of the United States in 1938, in describing the sources of revenue for local governments. We see from Table 54 that these cities in that year received 71.2 per cent of their revenues from taxation, and largely from the general property tax which produced 64.7 per cent of total revenues and 90.9 per cent of tax revenues. With the exception of the taxes on property, there is nothing new in the

TABLE 54.—SOURCES OF REVENUE FOR 94 LARGEST CITIES OF THE UNITED STATES, FISCAL YEAR 1938

Source of Revenue	Amount Received (in millions)	Per Cent of Total Revenue
General property tax.....	\$1814.9	64.7
Other property taxes.....	1.0	....
Business and non-business license taxes.....	172.7	6.2
Poll taxes.....	2.1	0.1
Other taxes.....	5.7	0.2
Non-tax revenues ^a	810.4	28.8
Total Revenues ^b	\$2806.8	100.0

^a Includes fines, forfeits, and penalties; interest, rents, and royalties; shared taxes; grants; pension assessments; donations and contributions; unclaimed money; contributions from public service enterprises; special assessments; and service charges.

^b Source: Department of Commerce, Bureau of the Census, *Financial Statistics of Cities, 1938*, Washington, Government Printing Office, 1941.

list of city taxes. The poll taxes are, of course, similar to those of the state governments, and so are the business and non-business license taxes or fees. Non-business license taxes, such as dog taxes, fall directly on the consumer, while the business license taxes, such as those paid by operators of beauty parlors and billiard emporiums, fall upon producers, add to costs of production, and tend to be shifted to consumers in whole or in large part. Hence, these taxes or fees are similar to excise taxes in their incidence, merits, and defects.

The General Property Tax.—Since the tax systems of city governments are well-nigh completely dependent on the general property tax, it will be well to analyze that tax carefully. The general property tax is a tax on property considered as a homogeneous whole, and is sometimes called the “uniform rule” of taxation. This means that the rate of the tax is to be uniform throughout the taxing district and for any amount of property. The tax is based upon the valuation or assessment of property in terms of money. These valuations are estimated by assessors at specified times, and the tax is applied at a certain rate, ordinarily upon the total valuation of the property of the taxpayer in question. Boards of Review are often created for the purpose of correcting inequalities and obtaining a uniform basis of assessment.

Defects of the General Property Tax.—The general property tax is based upon the assumption that ability to pay is adequately represented by the ownership of “general property.” The defects of the tax are numerous. In the first place, it is based on a mistaken notion as to the nature of property. Property is an institution which guarantees to the individual the right to use and control, to receive benefit from the ownership of, to exclude others from the use of, and to pass on to others at the time

of death or before, whatever economic goods he may acquire. What is called "property" under this tax is in reality made up of two classes of things—wealth and claims upon wealth. Now when certain items of wealth and claims on these same items are both regarded as general property subject to tax, it is clear that double taxation arises. Thus, the corporation is taxed upon certain items of wealth, such as buildings and machinery, and the stockholder is taxed upon his shares of stock, which are the claim upon these articles of wealth. This is double taxation in the worst sense because it is largely if not entirely unintentional, and because an item of wealth and a claim upon that wealth are both taxed at the full rate charged other items of wealth which are not represented by similar claims. In the second place, it is assumed, at least by inference, that nothing other than "property" represents ability to pay taxes. This is clearly untrue at present, for many persons have very large incomes derived from personal services, but possess little wealth that is reached by the general property tax.

A third and important defect of the general property tax is that it is grossly inequitable. The assessment is made by assessors who are ordinarily dependent for their positions upon some of the people whose property is to be assessed. They are for the most part untrained and inexperienced, and do their work in a relatively short time. The result is inequitable valuation and taxation. Much intangible property (that is, claims upon wealth) escapes assessment altogether, while real and tangible personal property is assessed in a most discriminatory fashion. As expenditures have increased on the part of the governmental units dependent upon this tax, it has been found necessary to increase the rate at which the tax is applied. This has given to the owners of intangibles an increased incentive to evade assessment, which means a smaller amount of property of this kind assessed and a still higher rate, which in turn stimulates further evasion, and so on. Evasion of the tax is easy on the part of owners of intangibles, because their correct assessment depends so largely upon the cooperation of the taxpayer himself.

Though in theory the tax is based upon proportion (that is, the same rate being intended to apply regardless of the amount of property an individual has), it seems altogether fair to say that the tax has been regressive in its operation. The owners of great wealth are able to consolidate much of their holdings in forms which escape the tax, while it is well known that real and tangible personal property is progressively under-assessed. Thus, the rate actually paid upon "general property" tends to be the lower, the greater the amount of property possessed by the individual. In addition, it becomes more and more difficult as time goes on to insure the fiscal adequacy of the tax, for it is not easy to adapt the tax to increasing fiscal needs. It is decidedly inelastic.

Classified Property Taxes.—In some states and local governmental units attempts are made to avoid the difficulties arising under the general

property tax by adopting what are called "classified property taxes." As the name suggests, the various items of wealth and claims upon wealth are divided into classes for purposes of taxation, with a different rate of taxation for each class. The purpose is to obtain a more equitable distribution of the burden of taxation and, of course, to make possible the more efficient administration of the taxation of property. The tax rate applied in each class is high or low, depending chiefly upon whether the items in the group can easily evade assessment and taxation. The lowest rate is accordingly applied to intangible personal property for the above reason and in order to avoid any serious double taxation. Tangible personal property is less mobile than intangible, but there are nevertheless means of evasion open for such items of wealth. Consequently, a moderate rate is usually applied in this group. Least mobile and least likely to evade taxation is real property, and the highest rate of all is imposed upon wealth of this type.

Improvement of the General Property Tax.—Many suggestions might be made for improving the general property tax. The assessors should be appointed rather than elected, and the county should be the unit of assessment, with the whole procedure under state supervision and control. The collection of the tax should be improved, with delay allowances, and the remission or reduction of penalties, eliminated. The interest penalty for delay in payment should be two or three times the current rate on real estate loans, in order to prevent borrowing from the government through nonpayment of taxes. No further exemptions from the tax should be granted for the purpose of attracting business enterprises to a community, and a reassessment of "properties" should be made oftener than at present. Constitutional limits on tax rates might well be repealed, and the tax should be used only to supply revenue for the local units of government.⁵

The Incidence of the General Property Tax.—It is not feasible to discuss the incidence of this tax as a whole. It must be considered as it falls upon owners of different kinds of wealth. In so far as the general property tax is a tax on land, the tendency is strong for the burden to rest finally upon the owner of the land, regardless of whether he pays the tax originally. Land is not a commodity produced at the will of man, but is fixed and nonextensible in amount, for all practical purposes. The rent of land, and consequently its value, are determined by the conditions of demand for and supply of land. There is nothing about a tax on land which will make its user willing to pay a higher rent for it, nor will its supply be affected in any way by such a tax as is ordinarily applied. Therefore the tendency is for the owner of land to bear the burden of any tax placed on it. It should be remembered that this is the case stated in its bolder terms. Many qualifications and variations of assumptions have been made in the

⁵ These recommendations are from *Facing the Tax Problem*, New York, Twentieth Century Fund, 1937.

past in presenting the theory of the incidence of the tax on land, but in the majority of the cases which are of practical importance the tendency as stated above is clearly observable.

The incidence of the tax tends to be quite different when it falls on buildings, rather than land itself. A tax on buildings tends to fall upon the tenant rather than on the owner, unless these two happen to be the same person. Buildings are simply one form of the investment of capital, and if a tax is imposed which temporarily falls upon the owners and makes the return from this investment smaller than that which can be obtained in other lines, the tax tends to be shifted. The process of shifting is a long-run process, and comes about through an exodus of capital from the taxed form of investment, which enables the capital that remains in this line to receive as high a return as it received before the imposition of the tax.

A tax on buildings, then, seems to be merely one case of the taxation of capital. In so far as a tax falls upon some lines of investment and not upon others, or upon some more heavily than upon others, there is a tendency for the tax to be shifted through the process outlined in the preceding paragraph. In so far as a tax affects all capital alike, its shifting or non-shifting depends upon whether, in the long run, the tax is sufficiently high to operate as a check upon saving and the accumulation of capital. This possibility has already been discussed in connection with the criticisms of progressive taxation. To the extent to which the general property tax is imposed on articles of wealth which will be used not as capital in further production but merely for personal consumption, the prospect of shifting the tax is practically nil, because such articles do not ordinarily enter into later price transactions.

Conclusion.—In referring to the combined taxation systems of federal, state, and local governments, it is necessary to admit that taxation in the United States is on the whole regressive in operation, and does not conform satisfactorily to the principle of ability to pay. In other words, by far the larger part of our total tax revenue is received from taxes which take a larger *percentage* of small than of large incomes. To be sure, the rates of income and estate or inheritance taxes are ordinarily progressive, and sometimes highly so, and some writers claim that these taxes are sufficiently progressive to make the whole tax burden progressive for people who must pay these types of taxes. The tax burden is, however, admittedly regressive for all who do not have to pay income and inheritance taxes, and these progressive taxes have been paid in the past by a small minority of our total population of taxpayers.

It follows that, according to our principles of taxation, much of the revenue which is raised by regressive taxes might better be obtained by progressive taxation, if true ability to pay is to be our basis for the distribution of the tax burden. It also follows that further increases in tax revenue, when necessary, should be obtained by a further application of

5. What are the other requisites of a sound tax system?
6. Why is the principle of ability to pay considered superior to other principles as a basis for distributing the burden of taxation?
7. What is at present the most generally accepted indicator of ability to pay? Why?
8. Does taxation according to ability to pay point to regressive, proportional, or progressive taxation? Explain.
9. What is meant by equal sacrifice, least aggregate sacrifice, and net utility of income?
10. State and criticize the objections to progressive taxation.
11. Distinguish between direct and indirect taxes.
12. List the principal sources of federal revenue.
13. What are the principal characteristics of the personal income tax as applied by the federal government?
14. Comment on the merits and defects of our federal personal income tax.
15. Is the personal income tax a direct or indirect tax? Why?
16. Describe the federal corporate income tax. Why do some people object to this tax? Explain.
17. Does this tax lead to double taxation? Why?
18. Is double taxation always objectionable? Why?
19. Explain how the capital stock tax and the declared value excess profits tax work in combination.
20. Compare the declared value excess profits tax with the excess profits tax of 1940.
21. How does the federal government tax estates? Explain.
22. State and answer the chief objections which are raised against the federal estate tax.
23. What are excise taxes and who bears their burden? Explain.
24. Are excise taxes desirable in themselves? Why?
25. Comment on the importance and desirability of customs duties in our federal tax system.
26. Criticize the federal tax system as a whole.
27. Describe the principal sources of state tax revenue and criticize state tax systems as a whole.
28. What is the sales tax and how is it used? Is it a desirable tax? Explain.
29. What are the principal sources of city revenues?
30. In what respects is the general property tax defective?
31. What steps may be taken to avoid the difficulties which have been experienced with the general property tax?
32. What is the incidence of the general property tax? Explain.
33. How does the combined tax system of federal, state, and local governments measure up to the tests of a sound system of taxation? Explain.

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AGRICULTURE

THE WIDE publicity given the agricultural problem has made most Americans aware of its existence, but there are many who do not take this problem seriously. They regard our farmers as no worse off than many other enterprisers, but a good deal noisier about such troubles as they have. It is likely that this attitude results from a lack of understanding of the situation. It is difficult to believe that anyone who is thoroughly familiar with the importance of American agriculture, and the nature of its difficulties, could fail to see the seriousness of this problem.

The Importance of American Agriculture.—Agriculture, in addition to being our principal source of food, is important also as a source of raw materials used in manufacturing industries. The farm population in 1935 was 31,801,000, or 25 per cent of our estimated total population. In the same year, out of a total acreage of 1,903,217,000, some 1,054,515,000 acres, or 55.4 per cent, were in farms. There were, in that year, 6,812,350 American farms, and the total value of all farm property was close to \$40,000,000,000.¹ The gainfully employed in agriculture in 1930 numbered 10,471,998 persons, or 21.4 per cent of the total for the country. The number of gainfully employed in agriculture was greater than in any other branch of economic activity except manufacturing, in which the total was 14,110,652, or about 35 per cent greater than in agriculture.²

Clearly, an industry as extensive as agriculture is of great importance to other industries and to the country as a whole, and not merely to those who devote their energies directly to it. It is difficult for manufacturing industries or other economic activities to prosper when the farmers' income is greatly reduced, or for the nation as a whole to achieve a high level of economic welfare with American agriculture on the verge of economic ruin. And this was the condition that prevailed in our farming industry in the great depression following 1929.

¹ Department of Commerce, Bureau of Foreign and Domestic Commerce, *Statistical Abstract of the United States, 1940*, Washington, Government Printing Office, 1941, p. 634.

² *Ibid.*, p. 57.

THE CAUSES OF THE FARM PROBLEM

The main problem of agriculture, or at least the one which is best known, is the unfavorable price-cost relationship for major farm products, and the unsatisfactory general levels of farm income which have prevailed since the first World War. But the farm problem is in reality a group of closely related problems, which include soil erosion, dust and flood control, the migration of farm workers, farm debts, farm credit, tax delinquency, share-cropping, farm tenancy, and many other matters. Our discussion will deal for the most part with the main problems of price-cost relationships.

The Question of Overproduction.—The main farm problem was not wholly a product of the post-1929 depression. It had existed in more or less serious form at least since the end of the World War in 1918, and was merely intensified by the depression. If a large number of individuals selected at random were asked to name in a word the cause of the farm problem, it is probable that the majority would blame *overproduction*. Let us see what this term means, as applied to the agricultural problem. It is practically certain that this country has not in recent years had an overproduction of farm products, in the sense of more farm goods than our people would have willingly used if they could have obtained them without payment. And it seems equally likely that our total farm output of recent years could have found purchasers at some price or other.

Whatever overproduction has occurred has been overproduction in the sense that the quantities of farm goods that have been turned out have not been salable at prices which would cover their costs of production, in the economic sense. As a consequence, large surpluses of some kinds of farm products accumulated, and in the matter of real income the farmers steadily lost out, as compared with other types of American producers. Many factors contributed to bring about this unfortunate and inequitable situation.

The War Demand for Farm Products.—The tremendous foreign demand for American farm products, during and immediately after the first World War, gave a great stimulus to agricultural production in this country. The countries at war had to take many men, and in some cases much land, out of agricultural production, with the result that the output of farm products, especially in Europe, fell off greatly. The countries affected were anxious to buy at high and even exorbitant prices all the farm products that we of the United States would send them. Hence, the war period was one of rapid increase in the foreign demand for our agricultural produce.

Supply Changes.—On the supply side, important changes took place at about the same time. In the first place, the mechanization of agriculture developed rapidly. The tractor came into more general use on the farm

during this period, and made possible the development and utilization of larger, more complicated, and more efficient farming implements of other types than had previously been used. Again, methods of cultivation were improved under the guidance of the United States Department of Agriculture. Our farmers learned much about the control of insect pests and other crop parasites, the benefits of seed selection and proper fertilization, and the most improved methods of animal breeding and feeding. Finally, as a result of the favorable price situation, the improved methods of cultivation, and the mechanization of the farms, still other changes in agriculture took place. It now became feasible to bring under cultivation land areas which had been too poor to use under former conditions. Farmers were encouraged to specialize in raising money crops for the market, instead of continuing to engage in diversified farming. The increasing use of mechanical power, both on and off the farm, reduced the amount of land needed to produce feed crops for animals, and the land released in this way was often devoted to producing more of the great staple money crops. Under the influence of these demand and supply conditions, farm production in the United States increased by leaps and bounds.

Changes in Agricultural Production.—If the years 1910 to 1914 are used as a base period, with an index number of 100, the index number of total crop production in the United States rose from 97 in 1916 to 116 in 1920. Wheat production, which amounted to 635 million bushels in 1916, increased to 952 million bushels in 1919. Cotton production, which was about 11.5 million bales in 1916, increased to about 13.5 million bales in 1920. Corn production rose from 2425 million bushels in 1916 to 3071 million bushels in 1920. Tobacco production increased from 1207 million pounds in 1916 to 1509 million in 1920. Finally, pork production, which averaged 5715 million pounds annually from 1911 to 1915, averaged 6544 million pounds annually from 1916 to 1920.³

Changes in Acreage.—In view of these considerable changes in output, increases in the acreage devoted to these products were not very striking. To be sure, the area used in wheat production increased from the annual 1911–15 average of 53 million acres to 74 million acres in 1919, while that used for tobacco increased from the annual 1911–15 average of 1286 thousand acres to 1959 thousand acres in 1919. On the other hand, the corn crop, which used an average of 100 million acres from 1911 to 1915, averaged only 102 million acres from 1916 to 1920, while cotton had an annual average of 34 million acres both from 1911 to 1915 and from 1916 to 1920.³

Changes in Agricultural Exports.—Our exports of wheat, which averaged 129 million bushels annually from 1914 to 1916, averaged 156 mil-

³ *Statistical Abstract of the United States*, 1935, pp. 617–622.

ing influence on the market for farm products, and the adoption of prohibition may have had a similar effect.

At any rate, the total demand for American farm products fell off within a few years after the first World War. In the face of this decline, methods of farming apparently continued to improve and the trend in agricultural output was upward (or, at least, stable) until well after the beginning of the depression in 1929. Corn acreage, which averaged 102 millions from 1916 to 1920, amounted to 101 millions in 1930, 106 millions in 1931, and 109 millions in 1932 at the depth of the depression. Wheat acreage, which had only once been above 65 millions, was 63 millions in 1930 and 57 millions in 1931 and 1932. Cotton acreage, which amounted to 33 millions in 1919, increased to 45 millions in 1926, and was 39 millions in 1931 and 36 millions in 1932. Tobacco production, which used 1959 thousand acres in 1919, used 2112 thousand in 1930, 2000 thousand in 1931, and 1409 thousand in 1932.⁶

Agricultural Production and Exports.—The index number of total crop production in the United States which had been 116 at the peak of demand in 1920, on the basis of 1909–14 as 100, was still 110 in 1931 and 108 in 1932. Production of some individual staple crops was still worse, from the point of view of excessive output. Corn production, which had exceeded 3000 million bushels only once since 1914, was still 2589 million bushels in 1931 and 2907 million bushels in 1932. Wheat production, which had totaled 952 million bushels in 1919, was 932 million bushels in 1931 and 746 million bushels in 1932. Cotton production, which reached 13.5 million bales in 1920, had increased to 17.1 million bales in 1931 and was still 13 million bales in 1932. Tobacco production, with 1386 million pounds, on the average, from 1916 to 1920, was 1647 million pounds in 1930 and 1584 million pounds in 1931. Finally, pork production, which averaged 6544 million pounds annually from 1916 to 1920, was 7831 million pounds in 1931 and 1932.⁶

At the same time, exports of farm products declined sharply from war and early post-war levels. Cotton exports made the most favorable showing, since they declined from a peak of 10.9 million bales in 1926 merely to 8.7 and 8.4 million bales in 1931 and 1932, respectively. Tobacco exports, which totaled 648 million pounds in 1920, declined to 591 and 432 million pounds in 1931 and 1932, respectively. Corn exports, which had amounted to 179 million bushels in 1921, declined to 3 million bushels in 1930, 4 million in 1931, and 9 million in 1932. Wheat exports, which had reached a peak of 293 million bushels in 1921, declined to 92 million bushels in 1930, 76 million in 1931, and 97 million in 1932.⁷

Farm Income.—With the output of important staple crops changing only slightly despite the loss of export markets and depression conditions at home, the farm income of the United States fell seriously in the years

⁶ *Ibid.*, pp. 617–622.

⁷ *Ibid.*, pp. 458–461.

following 1929. The total farm value of the corn crop, which was \$4,035,000,000 in 1919, was only \$831,000,000 in 1931 and \$925,000,000 in 1932. The value of the wheat crop declined from \$2,059,000,000 in 1919 to \$364,000,000 in 1931 and \$283,000,000 in 1932. The value of the tobacco crop fell from \$288,000,000 in 1923 to \$130,000,000 in 1931 and \$108,000,000 in 1932. The value of the cotton crop, which was \$2,020,000,000 in 1919, was only \$483,000,000 in 1931 and \$424,000,000 in 1932.⁸ The tremendous declines in value suggest that the demands for these products were inelastic. An illustration is afforded by the cotton crop, which brought in \$2,020,000,000 in 1919 from the sale of 11,411,000 bales, while it yielded only \$483,000,000 in 1931 for 17,096,000 bales. However, since these results occurred at different times and under different conditions of demand and of general business, they are not an example of inelasticity of demand in the strictly theoretical sense.

The total gross farm income of the United States, which reached a peak of \$16,935,000,000 in 1919 and was still \$11,941,000,000 in 1929, fell to \$6,968,000,000 in 1931 and to \$5,337,000,000 in 1932. The total cash income available to farmers, after paying wages to hired labor, interest, taxes, and various operating expenses, was \$4,890,000,000 in 1929, but declined to \$2,091,000,000 in 1931 and to \$1,473,000,000 in 1932.⁹ The effects of the decline in farm income were the more severe because the prices received by farmers for their products fell faster and further than the prices paid by farmers for the goods they bought. Many of our manufacturing industries, by virtue of their monopolistic or semi-monopolistic situations, were able to keep prices relatively stable during the depression and take their losses in the form of idle plant and equipment rather than by selling their products at low prices. If, in the face of a declining national income, some prices refuse to fall, the effect is to depress other, competitive prices to a greater extent than would otherwise be necessary. The farm industry, being operated by millions of independent enterprisers, was unable to protect itself in this situation, and the fall in farm prices was disastrous.

Farm and Other Prices.—If the years from 1909 to 1914 are taken as a base period for both index numbers, the index number of prices received by farmers has never been as high since 1920 as the index number of prices paid by farmers. In the prosperous days of 1929, prices paid by farmers stood at 153, while those received by farmers were at 146. In 1931, prices received by farmers were at 87, while those paid by farmers were at 124, and in 1932 the two index numbers were 65 and 107, respectively.¹⁰ The *ratio* between these index numbers in 1932 was 61. This means that in that year the farmer, by giving up products worth \$1.00 in terms of the base period, could obtain other products worth 61 cents in terms of the same period.

⁸ *Ibid.*, pp. 617-622.

⁹ *Ibid.*, p. 590.

¹⁰ *Ibid.*, pp. 680, 681.

Expressed in slightly different terms, it may be said that, from 1929 to the spring of 1933, the output of farm products declined only 6 per cent, while the prices of these products dropped 63 per cent. In the same period, the output of farm implements dropped 80 per cent, of motor vehicles 80 per cent, of cement 65 per cent, of iron and steel 83 per cent, and of automobile tires 70 per cent. However, the prices of farm implements in this period declined only 6 per cent, of automobiles 16 per cent, of cement 18 per cent, of iron and steel 20 per cent, and of automobile tires 33 per cent.¹¹ Since the cost of marketing farm products is relatively fixed, the reductions in the market prices of these products came out of the money incomes of the farmers. Hence the purchasing power of the farmer was greatly reduced during the depression.

The Insensitiveness of Farming.—Two important questions should be raised at this point. The first of these is, Why did not the farm industry, like the manufacturing industries, recognize the existence of unfavorable demand conditions and reduce output all along the line? And the second question is, Would not the farm problem have solved itself eventually through the operation of natural economic forces, such as the business failure of increasing numbers of farmers and the gradual reduction of the acreage in cultivation and, hence, in the size of crops?

In answer to these questions, it may be said that farming is apparently less sensitive than most industries to changes in demand conditions and the prices of its products. When manufacturers can no longer make ends meet, they fail and their output is withdrawn from the market. Or, in some instances, manufacturing concerns, before reaching the failure stage, decide to cooperate with one another in the reduction of output and maintenance of prices. The farmer seldom fails. Those who have lent him money are usually lenient in allowing him to continue in business, even though he defaults on his obligations. Even when he loses his farm through mortgage foreclosure, he is often permitted to remain on the land and cultivate it. Moreover, it is practically impossible for the many independent growers of a crop to cooperate with one another voluntarily to restrict output and maintain prices as manufacturers are given to doing.

So long as the farmer can stay on the land, he is likely to keep on producing to the utmost of his ability. Interest and taxes bulk large among his money expenses. These are in the nature of fixed costs and cannot be reduced easily, if at all. When the prices of his products fall, he can save comparatively little by cutting down output. Therefore, falling prices for farm products may lead to increased, rather than decreased, farm production, since it takes more bushels of wheat or pounds of cotton to pay a given amount in taxes or interest when farm prices are low than when they are high.

¹¹ United States Department of Agriculture, *Yearbook of Agriculture*, 1935, Washington, Government Printing Office, 1935, p. 5.

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The Farmer's Fixed Costs.—The burden of fixed costs has borne heavily on the farmer since the first World War. Agriculture was so prosperous during and immediately following the war that farming land increased rapidly in value, and many farms changed hands at greatly inflated prices. The mortgages which usually accompanied such changes in ownership called for large interest payments and these became difficult to meet in later years. The total amount of interest payable by farmers in 1930, 1931, and 1932 was 96, 92, and 87 per cent, respectively, of the total payable by them in 1929. Similarly, the assessments on farming land for tax purposes increased during and following the war, and it was difficult, of course, to secure later reductions in these assessments. The taxes payable by American farmers in 1930, 1931, and 1932 were 100, 92, and 79 per cent, respectively, of their 1929 taxes.¹²

Thus, in the great depression following 1929, the farmers, with their fairly stable money costs and sharply reduced incomes, were in very serious straits. Thousands lost their farms through foreclosure and the situation finally became so bad that groups of farmers sometimes banded together to prevent foreclosures and sheriff's sales, even by violence if necessary. There were also farmers' strikes and riots, in which groups of farmers attempted to destroy farm produce on its way to the market, or otherwise to prevent the marketing of farm products until prices should improve. In some cases, crops were left to rot in the fields, or were destroyed, because they could not be sold at prices sufficiently high to cover even the necessary expenses of harvesting them. It may be argued, a dozen years after the event, that these conditions in agriculture would eventually have corrected themselves through the action of natural economic forces. A solution of the farm problem might or might not have come about in this way. Given the best of good luck, solving the farmers' difficulties without governmental assistance would have been a long and painful process. At any rate, attempts had previously been made to give assistance to the farmers and, since the Roosevelt administration undertook to adopt a general recovery program, it was probably necessary both economically and politically to do something about the agricultural problem.

Soil Erosion.—The main farm problem, as we have already described it, was bad enough, but in later years our farmers have been menaced by a serious increase in soil erosion. While soil erosion is not of recent origin, it has only lately come to command great public attention. The extension of cultivation to new areas formerly used for grazing has stripped the soil of natural protective vegetation and, as a result, the uncontrolled forces of wind and water have severely damaged millions of acres of farming land.

In some parts of the country, the land, denuded of trees and other vegetation, is being lost to the sea.

¹² *Statistical Abstract of the United States, 1935, p. 590.*

tation, is no longer able to hold the moisture which it receives at times. A considerable part of the rainfall runs off the surface, provides but little moisture for plant growth, and carries away with it many tons of fertile soil. But in the past several years soil erosion by wind has perhaps exceeded erosion by water in its destructive effects. Some of the severe dust storms originating in our western states have moved eastward to the Atlantic coast and passed out to sea, bearing with them untold thousands of tons of valuable soil whirling about in the air at a height of two to three miles.

According to government reports, soil erosion has ruined some 50,000,000 acres of farm land and badly damaged 50,000,000 acres more, while much additional land is in serious danger. Erosion dissipates fertile soil through dust storms, piles up soil on the lower slopes, spreads poor subsoil over rich bottom lands, increases the danger of floods, and robs wild animal life of essential food and cover. It also leads to the silting and sedimentation of stream channels, reservoirs, dams, ditches, and harbors, and damages roads, railways, irrigation works, power plants, and public water supplies.¹³

Soil erosion is said to be largely the result of overcropping—an unsound practice which, besides leading to erosion, makes the tillage of the soil more difficult, reduces its content of plant food, and increases the danger of drought. Depletion of the soil has been especially serious in the South, where an average of 80 per cent of the agricultural land has been kept in soil-depleting crops. Such crops as cotton and corn leave the land bare in the winter season and highly subject to erosion under the influence of the moderate climate and heavy rainfall.¹⁴

Methods have been devised for controlling soil erosion, but it is difficult to accomplish much through individual action, since the average farmer lacks the necessary skill, the financial means, and even the incentive to attempt erosion control. Since erosion is caused, or at least facilitated, by unwise use of the soil, it is directly related to the main agricultural problem. It is possible to prevent or greatly reduce soil erosion by putting land into such close-growing crops as alfalfa or bluegrass, but it is difficult for farmers to do this when their economic situation is so acute that they need all their land for money crops, such as wheat or cotton. Even the rotation of soil-protecting crops with money crops in alternate years would be helpful in checking soil erosion; but when farmers need, year after year, every penny that they can scrape together, they are likely to plant money crops continuously and let nature take its vengeance. In any case, the individual farmer usually feels that he can do little about soil erosion without the cooperation of other farmers. The methods of handling soil erosion, and the present program of the federal government, will be described in the next chapter.

¹³ *Yearbook of Agriculture*, 1937, p. 19 *et seq.*

¹⁴ *Ibid.*, p. 13.

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EARLY ATTEMPTS TO SOLVE THE FARM PROBLEM

We have seen that the farm problem was not caused by the post-1929 depression, but was merely intensified by it. Furthermore, attempts to solve the problem did not wait upon the great depression, but began to appear soon after the first World War. An ineffective attempt of this kind took the form of tariff changes in 1922, which placed high rates of duty on imports of agricultural products. The avowed purpose was to protect the domestic market of the American farmer. But he already had such protection, for imports of agricultural products competing with our own had never been heavy. The protection of the home market did our farmers little good, for they were producing agricultural goods in quantities too great to be absorbed by the domestic market at favorable prices, and were rapidly losing their essential export markets. What the farmers really needed was the ability to export. The only tariff change capable of helping the farmer would have been a reduction in the tariff duties on imported manufactures, enabling foreigners to sell their goods to us and thus be in a position to buy our surplus farm produce.

Attempts to Control Surplus Production.—Since the farmers were producing more than the domestic market could absorb, and were losing their export markets, attention turned in the next few years to the question of surplus production. Two measures designed to give relief were vetoed by President Coolidge. One of these, the McNary-Haugen Act, provided that a so-called equalization fee or tax should be levied on the output of certain agricultural products, to provide funds to reimburse farmers for the losses incurred in exporting surplus farm products. This plan was expected to decrease the volume of agricultural products sold in the domestic market and maintain domestic prices for these articles well above the foreign level. The second relief measure involved what was called the debenture plan. The idea was to stimulate the exportation of farm products by granting bounties, in the form of debenture certificates, for such exports. The bounties were to equal the difference between the domestic prices of farm products and the prices received in the foreign market. The certificates were to be accepted by the federal government in payment of import duties, so that there would be a ready market for them. The purpose of this Act was, of course, to reduce the volume of farm products sold in the domestic market and thus raise prices.

The Federal Farm Board.—In 1929, the Agricultural Marketing Act was passed by Congress and approved by President Hoover. The Federal Farm Board was set up to carry out the provisions of the Act, and was given one-half billion dollars for use in stabilizing the prices of farm products. While more than one course of action was open to the Board, its chief activity consisted of the purchase of a large part of our surplus output of such products as wheat and cotton, and the storage of these

commodities in warehouses. For a time, the Board had some success in producing artificially high prices for these articles, but it failed eventually because it attempted to provide high prices for farm products without putting any effective check upon agricultural production. Naturally, the financially embarrassed farmers, with no restrictions on production, were stimulated by the high prices to increase their output. It seems likely that the equalization fee and debenture plans would, like the Agricultural Marketing Act, have proved defective as solutions of the farm problem.

THE FARM CREDIT POLICIES OF THE ROOSEVELT ADMINISTRATION

In the presidential campaign of 1932, the Democratic party promised real relief to American farmers; and it must be said that the Roosevelt administration has been untiring in its efforts to find a way out for the farmers, however ill advised certain of its policies may seem to some people. The discussion of the policies of the administration will be divided between the present and the following chapters.

The Farm Credit Administration.—Several steps were taken by the Roosevelt administration, in its first year in power, to provide debt relief and additional credit facilities for farmers. The Farm Credit Administration was formed in 1933 by executive order for the purpose of bringing a number of existing farm credit agencies under one head, and administering the emergency legislation. Operating under the Farm Credit Act, it helped farmers to develop a system of several hundred local production credit associations, to provide farmers with production and marketing credit at low cost. These associations make loans to farmers on crop and chattel security and charge interest rates of approximately 5 per cent, which is some 2 or 3 per cent less than private agencies would charge for the same type of credit.

Emergency Farm Mortgage Legislation.—As has been suggested, the farm mortgage situation during the depression was desperate. In 1932, farm mortgage debts amounted to 8.5 billion dollars, out of a total farm debt of 12 billion dollars. The total debt was more than twice the amount of the gross farm income of 1932, and about equal to that of 1929. Under the Emergency Farm Mortgage Act, the Farm Credit Administration reorganized the Federal Land Bank System and set about refinancing farm mortgage debts. The Act authorized for this purpose the issuance of two billion dollars' worth of new Federal Farm Loan Bonds, on which the federal government guaranteed interest at the rate of 4 per cent. The proceeds of the bond issue were used to make new loans to farmers or to purchase their mortgages, while some bonds were exchanged directly for mortgages.

The holders of farm mortgages, anxious for settlement after a long period of waiting, were sometimes willing to scale down their claims. Such

reductions were obligatory in some cases, for the Land Bank loans, with prior liens, could not exceed 75 per cent of the normal value of the property given as security. In any event, after the mortgages were taken over by the government, the process of refinancing began. These new mortgage obligations of the farmers were to be liquidated over a long period of years, and no payments on the principal had to be made for five years. The interest charge was not to exceed 4½ per cent, as compared with 5 to 6½ per cent formerly paid by farmers. By the end of 1939, agencies of the Farm Credit Administration were still holding farm mortgage loans to the amount of \$2,595,535,000.¹⁵

Mortgage Moratoriums.—The original Frazier-Lemke Act provided a five-year moratorium on a farmer's obligation, if it proved impossible to reduce his debt to a sum which would permit him to pay off his mortgage. That is, under the law, a farmer's property could not be taken through foreclosure within a five-year period, provided the farmer paid a reasonable rental to the creditor during this time. After five years, the farmer could obtain a clear title to his mortgaged property by paying its appraised value, regardless of the amount of the obligation specified in the original mortgage. However, this Act was declared unconstitutional in May, 1935, by unanimous vote of the Supreme Court. It was said to violate the Fifth Amendment to the Constitution, by taking from the mortgage holder some of his specific rights in the property which secured the mortgage, without just compensation.

Undaunted by this experience, Congress passed a new Frazier-Lemke Act later in 1935. Under this Act, a farmer, faced with foreclosure and unable to get a reduction in his mortgage obligations by direct dealings with his creditors, could apply to the courts to declare him a bankrupt. The court dealing with his case was given the power to stay all legal proceedings against the farmer for a period of three years, during which time he could retain possession and use of the mortgaged property by paying a reasonable rental. At any time during the three years, the court could order an appraisal of the mortgaged property and the farmer could obtain full title to it by paying the appraised value, regardless of the amount of the mortgage obligation.

To protect the rights of creditors, which were damaged by the original Act, the new law provided that any creditor who had as security a lien on the property could demand that it be sold at public auction. In this case, the court was required to conduct such a sale after due notice, but the former owner was thereafter to be given ninety days within which he could recover full title to his property by paying the auction price, plus interest at 5 per cent. In the spring of 1937, this Act too was passed upon by the Supreme Court, and was declared constitutional. The Court realized that the new law sought to attain its ends in a somewhat different

¹⁵ *Statistical Abstract of the United States, 1940*, p. 278.

way, and decided that it avoided many of the defects of the original Act. Still another Frazier-Lemke Bill was introduced in Congress at the 1936 session, but failed to pass.

The Desirability of Debt Relief.—We have emphasized the fact that the farmer's difficulties arose from the necessity of paying a fixed amount of principal and interest while his income declined sharply because of the depression. If the government was to help out, here was at least one desirable point of attack. Of course, it may be argued that there was no reason to give the farmers preferential treatment in this respect; but it should be remembered that home owners other than farmers were given similar relief through the Home Owners' Loan Corporation, and many types of business men were given financial assistance through the Reconstruction Finance Corporation. There has been some question as to the safety of the funds invested by the government in refinancing farmers' mortgages. If agricultural conditions are no better in the future than in the past, this money may not be recoverable, and may have to be written off as a subsidy to agriculture. The debt program is, of course, related indirectly to the main agricultural adjustment program. With the pressure of debt obligations reduced, the farmers no longer feel it imperative to keep every possible acre of soil planted to money crops, and are willing to cooperate in a program for controlling agricultural production. By many people, the debt relief program is credited with preventing the complete financial breakdown of the farm industry.

The Commodity Credit Corporation.—In late 1933, the Commodity Credit Corporation was set up for the purpose of making loans to farmers on their holdings of specified crops. It could lend a farmer 10 cents a pound on his cotton, without liability to him, if he would agree to take part in the 1934 acreage reduction program. A similar offer was made available for corn growers after the corn-hog adjustment program had been set up. That is, in states where corn could be held on the farm under seal, secured by warehouse receipts, the growers could secure a loan of 50 cents a bushel on their holdings, provided they agreed to cooperate in the agricultural adjustment program in the following year. These provisions for loans assured the growers a certain return for their products, and also enabled them to gain by any increases in prices which might result from the operation of the agricultural adjustment program.

Thus, we see that the work of the Commodity Credit Corporation was closely tied up with that of the Agricultural Adjustment Administration. If loans had not been made available to the farmers, they probably would have had to throw their crops on the market for whatever they would bring, thus depressing the prices of these products still further, or at least keeping the prices from rising. The loans made it possible for farmers to withhold a part of their current production from the market, and thus aided the Administration in realizing its object of raising the prices of

these agricultural products. In several recent years, some of the farm credit agencies received in repayments larger sums than they paid out in new loans, but this trend was reversed during the business recession of 1938, under the influence of the new agricultural program of that year.

AIMS AND METHODS OF THE AGRICULTURAL ADJUSTMENT PROGRAM

The principal aim of the Roosevelt administration in aiding American farmers was to increase farm incomes and purchasing power by controlling production and raising prices. This aim was to be accomplished through the administration of the Agricultural Adjustment Act of 1933. The preamble to this law declared that the great depression was caused in part by the severe and increasing disparity between the prices of agricultural products and other commodities; for this disparity had largely destroyed the power of the farmers to purchase manufactured products, had interfered with the orderly exchange of commodities, and had seriously impaired the agricultural assets supporting the national credit structure. Thus it was held necessary, for recovery purposes, to enact legislation for the benefit of the farmers.

The Purpose of the Agricultural Adjustment Act.—The Act declared that it was the policy of Congress to establish and maintain a relationship between the production and consumption of farm products which would bring the prices received by farmers to such a level as to give these farm products a purchasing power, in terms of the commodities that farmers buy, equivalent to the purchasing power of the farm products in the "base period." This was the five years preceding the first World War, or from the middle of 1909 to the middle of 1914, except in the case of tobacco. The policy was to be put into effect as rapidly as possible. The interests of consumers were to be protected by seeing to it that the adjustment of farm production did not raise the percentage of the consumers' total retail expenditures which farmers received above the percentage which they received during the base period.

The Reduction of Output.—To achieve the objects of this legislation, the Secretary of Agriculture was empowered to arrange for reductions in the output of basic agricultural commodities, by making agreements with farmers to cut down acreage and paying them rentals or benefits in return for such cooperation. The amount of reduction required in the case of specific farm products, and the amount of benefit or rental payments, were to be determined by the Secretary of Agriculture.

The Processing Taxes.—To secure funds with which to administer the Act and pay benefits to farmers, the Secretary was authorized to levy taxes upon the first processors of these basic farm products. The processing tax on each product was to equal the difference between its current average farm price and its "fair exchange value"—that is, a price which would give the seller as much purchasing power as its sale would have

given during the base period 1909-14. However, if it developed that this rate of tax would not prevent the accumulation of a surplus stock of commodity, a higher or lower tax rate could be charged.

The Cotton Options.—An alternative form of treatment was provided for cotton growers. The Secretary was empowered to sell, to any cotton grower, options on cotton held by the government up to 30 per cent of the grower's production in the previous year, providing the grower agreed to reduce his current production by the same amount. When the price of cotton advanced because of the reduction in acreage, the grower would be enabled to reap a profit on the options taken at a lower price.

Marketing Agreements and Licenses.—As an alternative form of control, the Secretary was permitted to enter into marketing agreements with processors, associations of producers, and others engaged in handling agricultural commodities or products thereof in interstate commerce, and to require these persons to obtain licenses authorizing them to carry on their customary activities in connection with these or competing products. These licenses might be suspended or revoked for cause, and the licensees could be required to furnish detailed information as to their business transactions in these products.

THE OPERATION OF THE AGRICULTURAL ADJUSTMENT ACT

The Basic Commodities.—The commodities specifically mentioned as basic in the original Act were wheat, cotton, field corn, hogs, rice, tobacco, and milk and its products. It should not be inferred, however, that rental payments for acreage reduction were made to farmers and processing taxes applied in the case of each of these products. As a matter of fact, processing taxes were placed on only wheat, cotton, hogs, and tobacco. The tax on hogs was supposed to cover benefit payments to both hog raisers and corn growers, since most corn is fed directly to hogs and comparatively little is processed for human consumption.

Emergency Restrictions of Output.—It was impossible to get the system of benefit payments and processing taxes into effective operation before the crop year 1934, so that emergency programs were adopted for some crops in 1933, notably in the case of hogs and cotton. More than six million sows and little pigs were purchased by the Agricultural Adjustment Administration, to reduce the amount of pork which would be marketed in following months. The edible pork products derived from the slaughter of these animals were given to the Federal Emergency Relief Administration for distribution among the unemployed. In the case of cotton, arrangements were made to remunerate the growers for plowing under some ten million acres of the 1933 crop, since it was too late to restrict the acreage planted. Though it was the policy of the Administra-

tion to avoid the destruction of commodities already produced or growing, it was thought that the seriously low prices of hogs and cotton did not make it feasible to delay action until 1934.

The 1934 Reduction Program.—For the year 1934, contracts were signed with the producers of cotton, wheat, tobacco, corn, and hogs, providing for the restriction of production in varying amounts. At the time it was thought desirable to reduce the output of cotton by 40 per cent, of wheat by 15 per cent, of corn by 20 per cent, and of hogs by 25 per cent. We may get an idea of the operation of the reduction program by noting its operation in the case of cotton.

According to the Secretary of Agriculture, about 1,010,000 contracts were signed with individual cotton growers affecting the 1934 crop. Every grower of cotton who accepted the plan promised to reduce his acreage planted to cotton by not less than 35 per cent or more than 45 per cent of his average acreage during the preceding five years; and these idle acres he leased to the Secretary of Agriculture. The grower also agreed to reduce his cotton acreage in 1935 by not more than 25 per cent on the basis of his five-year average, if the Secretary decided that crop reduction was necessary in that year. He promised, also, not to increase his total acreage of *all* crops, after deducting the contracted reduction in cotton acreage; not to increase his acreage in other "basic commodities"; and to use the land rented by the Secretary only for such purposes as might meet with the approval of that official.

In return for his cooperation in the respects outlined above, the cotton grower was to receive from the government a benefit or rental payment which would amount, on the average, to about 4½ cents per pound on the cotton which would have been grown on the land rented to the Secretary, based upon the five-year average production for 1928 to 1932. Since cotton production during this period averaged about 174 pounds an acre, this meant a payment of \$7.85, on the average, per acre of land removed from cultivation. If considered as rent alone, this would have been quite a heavy payment for the land, but it was intended also to compensate cotton growers for labor and capital withheld from production. The necessary revenue to pay these benefits was to be raised through taxes levied on the first processors of cotton. Manufacturers of cotton goods were required to pay taxes based on the quantity of raw cotton entering into their products. Raw cotton sold abroad was not subject to the processing tax, and the producers of manufactured articles containing cotton were given a tax refund on any of their products that were exported.

During the growing season of 1934, it was feared that the cotton reduction program would not be adequate, and Congress passed the Bankhead Act providing for the compulsory reduction of the cotton crop. This Act provided a tax of 50 per cent on the value of all cotton raised by any

grower in excess of the amount allotted to him. Individual allotments were to total about 10 million bales, and this was the maximum amount of cotton which could be marketed free of the 50 per cent tax. Each individual allotment was based upon the grower's average production during the preceding five years. A grower was given tax exemption certificates to the extent of his allotment, and a degree of elasticity was introduced into the program by permitting growers who did not produce the full amount of their allotments to dispose of their certificates to growers whose production exceeded their allotments. However, the actual cotton production in 1934 was only 9,636,000 bales.

The 1,010,000 cotton contracts involved the rental to the government of some 14,600,000 acres of cotton land, and required payments to growers amounting to \$116,686,000. In similar fashion, contracts were signed by the Secretary of Agriculture and the growers of other basic commodities. Some 289,000 contracts were signed by tobacco growers who controlled a total base acreage of 1,810,000 acres. These contracts called for an average reduction of 34 per cent from base acreage. Over a million wheat contracts were signed by growers controlling 78 per cent of official seeded acreage, and involved benefit payments of about \$102,000,000. Some 1,155,000 corn-hog contracts were signed, calling for a reduction of 24 per cent from base corn acreage. Benefits for adjusting corn acreage totaled approximately \$112,000,000, while those for adjusting hog production amounted to about \$204,000,000.¹⁶

Actual Reductions in Acreage.—In the case of most of the basic crops in which reduced production was sought, the actual number of acres withheld from use was somewhat smaller than the number the contract signers had agreed to withdraw. Farmers who had not previously raised the basic crops and who consequently did not sign contracts in some instances decided to produce these commodities, and other producers whose acreage in basic crops was so small that they did not think it worth while to sign contracts expanded their production to some extent.

Marketing Agreements.—As we have said, not all of the basic commodities were regulated through the adoption of benefit payments and processing taxes. The production and prices of these other basic commodities were controlled by marketing agreements. In the case of milk, for example, separate agreements were drawn up for the milk sheds which supply various areas of the country. These agreements were usually based on previous state or local agreements, and on practices already in existence in the various milk sheds, and constituted contracts between producers and distributors. The agreements were enforced by issuing licenses to all producers and distributors, whether they signed the original agreement or not. These licenses could be withdrawn for violations.

¹⁶ The figures relating to the 1934 crop reduction program are taken from the *Yearbook of Agriculture*, 1935.

to bear a government stamp. A farmer who sold potatoes not properly packed, or not bearing a stamp, was subject to a fine of \$1000 for the first offense and a year's imprisonment for the second. A buyer of potatoes not packaged and stamped was subject to similar penalties, as were also any persons who refused to furnish on demand any information they possessed about the production and sale of potatoes. Finally, every farmer raising more than five bushels of potatoes was required to keep such records as the Administration might specify. A storm of protest on the part of farmers, consumers, and political writers followed the enactment of this law. The law was never put into effect, probably because of its unpopularity, though ostensibly because of lack of funds for its enforcement; for the appropriation of these funds was included in a bill which failed to pass the Senate in 1935 as the result of the late Senator Huey Long's last filibuster.

The Amendments of 1935.—The Agricultural Adjustment Act was amended in several respects in 1935. One change was intended to strengthen the constitutionality of the Act by replacing the original, vague delegation of powers to the Secretary of Agriculture with a specific statement of these powers. It limited the application of the Act to articles destined to move in interstate commerce, and ratified and confirmed all administrative acts performed under the law prior to the passage of the amendments. The amending Act prohibited injunction suits designed to prevent the collection of processing taxes and prescribed the means by which refunds could be obtained, when justified. The export debenture plan was written into the amending Act in permissive form—that is, it allowed 30 per cent of the receipts from import duties to be used for subsidizing the exportation of surpluses of farm products other than raw cotton. The licensing of handlers as a means of enforcing marketing agreements was discontinued, and price-fixing was eliminated for all commodities except milk. Finally, the Bankhead Cotton Control Act, and the similar Kerr-Smith Act for tobacco, were extended for another year.

The Effect of the 1934 Program on Production.—The effect of the 1934 agricultural adjustment program upon farm output was obscured to some extent by the great drought of that year. The combined influence of drought and deliberate reduction on the size of certain crops is shown in Table 55. The greater part of the reduction in corn and wheat was probably attributable to the drought, while in the case of cotton and tobacco it was probably due to the reduction program, since these commodities are produced in states which were not seriously affected by the drought. These final crop estimates for 1934 showed that the cotton crop of that year was the smallest since 1921, the wheat crop the smallest since 1893, and the corn crop the smallest since 1881.¹⁷ Because of

¹⁷ *New York Times*, January 2, 1935.

TABLE 55.—PRODUCTION OF CERTAIN BASIC CROPS IN 1934 AND 1935 IN COMPARISON WITH 1927-31 AVERAGE PRODUCTION

(Source: *Statistical Abstract of the United States, 1937*, pp.637-641)

Commodity	1927-31 Average Production	1934 Production	1935 Production
Wheat.....	886,000,000 bu.	526,393,000 bu.	626,344,000 bu.
Corn.....	2,516,000,000 bu.	1,461,123,000 bu.	2,303,747,000 bu.
Cotton.....	13,047,000 bales	9,636,000 bales	10,638,000 bales
Tobacco.....	1,471,000,000 lbs.	1,081,629,000 lbs.	1,297,155,000 lbs.

the small crops, our surpluses of these products were greatly reduced. For example, on April 1, 1935, stocks of corn were only 40 per cent, and stocks of wheat 19 per cent, as large as those held at that time in the previous year.¹⁸

The Effect on Prices.—As a result of the smaller crops produced in 1934, the prices of farm products rose considerably. In February, 1935, the Agricultural Adjustment Administration was able to announce that the January price level of the fourteen basic agricultural commodities, including the seven on which processing taxes were levied, had practically reached the pre-war parity level as a result of the drought, the operation of the agricultural adjustment program, and other factors. In that month, prices for the fourteen products were 126 per cent of pre-war prices, putting them virtually on a par with non-agricultural prices. In February, 1933, the prices of agricultural products had been only about 52 per cent of pre-war prices.¹⁹ However, this favorable price situation did not last long, for the index number of prices received by farmers was 108 for the year 1935 as a whole, while that of prices paid by farmers was 125.²⁰

Farm Income.—The increase in the prices of farm products in 1933 and 1934 more than offset the reduction in the quantities produced and sold, so that the gross farm income of the United States increased from \$5,337,000,000 in 1932 to \$6,406,000,000 in 1933, and to \$7,276,000,000 in 1934.²¹ The increase over 1932, therefore, was \$1,069,000,000 in 1933 and \$1,939,000,000 in 1934, or a total of \$3,008,000,000 of surplus income over and above the amount the farmers would have received from a continuance of the 1932 level of income. During 1933 and 1934, the total payments to farmers under the Agricultural Adjustment Administration amounted to only \$629,600,000; so it is clear that most of the improvement in farm income was not a gift from the government. These

¹⁸ *Ibid.*, April 11, 1935.

¹⁹ *Ibid.*, February 8, 1935.

²⁰ *Statistical Abstract of the United States, 1940*, p. 673.

²¹ *New York Times*, January 5, 1936.

benefit payments were well covered by revenue from the processing taxes in the amount of \$640,900,000.²²

The farm situation had improved sufficiently by the beginning of 1935 to make it unnecessary to restrict output as greatly as in 1934. As is shown in Table 55, the output of wheat, corn, cotton, and tobacco all increased considerably in 1935 as compared with 1934. However, the former surpluses had been so well cleaned up that total farm income increased to \$8,110,000,000 in 1935, despite the increased production. It may be said that farmers as a whole benefited in these years under the A.A.A. program, though not all classes of farmers gained equally and some may not have gained at all. However, the improvement in farm income was not due wholly to the agricultural adjustment program, for growing conditions in these years, the general recovery of business, and other factors played a part.

1. Give statistics which suggest the importance of agriculture in our economic system.
2. How is the welfare of agriculture connected with that of other industries and with the welfare of the nation as a whole?
3. In what sense has there been an overproduction of farm products in recent years? Explain.
4. What stimulus caused American agriculture to expand production during and immediately following the first World War?
5. What changes in supply conditions in agriculture were taking place at the same time?
6. Indicate the extent to which agricultural production in the United States increased during and just after the first World War.
7. Was this increase in production due to an expansion in farm acreage? Explain.
8. What happened to our exports of farm products during the same period?
9. Discuss the change which took place in the income position of agriculture during this period.
10. What happened to demand conditions for farm products after the World War? How were our exports of farm products affected?
11. Did farm production adjust itself to these changed conditions of demand? Explain.
12. Comment on the fate of farm income and the value of major crops in the depression following 1929.
13. How did the behavior of agricultural output and prices in the depression differ from that of output and prices in certain manufacturing industries?
14. Explain fully what is meant by "the insensitiveness of farming."
15. The burden of fixed costs to the farmer grew heavier during the depression. Explain.
16. Would the farm problem have cured itself eventually through the operation of natural economic forces? Explain.
17. What is the nature of the problem of soil erosion?

²² *Ibid.*, February 8, 1935.

18. Show how the problem of soil erosion is related to other phases of the agricultural problem.
19. Could American farmers be assisted by placing high tariff rates on imports of farm products?
20. How were the equalization fee and debenture plans expected to help the farmer? Explain.
21. Discuss the Federal Farm Board experiment.
22. How did the Emergency Farm Mortgage Act provide debt relief for the farmers? Explain.
23. How did the government attempt to provide further mortgage debt relief for the farmers through the first and second Frazier-Lemke Acts?
24. What was the fate of these measures, and why?
25. Was it desirable to give the farmers debt relief in 1933? Explain.
26. What was the function of the Commodity Credit Corporation, and how was it related to the main program for agricultural adjustment?
27. What was the purpose of the Agricultural Adjustment Act? Explain.
28. What were the principal methods by means of which this purpose was to be accomplished?
29. How did the A.A.A. handle the emergency situation in 1933?
30. Explain the 1934 acreage reduction program, giving as many details as possible.
31. How did actual reductions in acreage compare with the reductions which were contracted for? Explain.
32. How were marketing agreements used by the A.A.A. in controlling certain lines of farm production?
33. Why was the number of "basic products" increased in 1934?
34. What was the nature and eventual fate of the Potato Control Act?
35. How and why was the Agricultural Adjustment Act amended in 1935?
36. How was the size of basic crops affected by the A.A.A. program of 1934?
37. What happened to the prices and stocks of basic farm products in the early years of the A.A.A.?
38. How were farm incomes affected in these years?

REFERENCES FOR FURTHER READING

See list of references at the end of Chapter 46.

CHAPTER 46

AGRICULTURE (*Continued*)

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THOUGH the original A.A.A. program is a thing of the past, it merits our careful examination and appraisal, for the reason that the farm program that succeeded it does not differ greatly from the original. The task of appraisal is rendered difficult by the fact that most of the widely circulated criticisms of the administration's farm program were political or hysterical (or both) in character. Certain aspects of the program unquestionably merited adverse criticism from the economic point of view, but some of the sins with which the A.A.A. was charged by newspaper and magazine writers were apparently inspired by motives that were not strictly scientific.

"The Worship of Scarcity."—Political writers opposed to the Roosevelt administration shed bitter tears over the untimely demise of sows and little pigs, and the plowing under of growing cotton. Indeed, it seemed to many people to be economically unwise, if not downright irreligious, to destroy economic goods in the process of production, or otherwise to restrict production, when people were going without sufficient food and clothing. But from the long-run point of view it appeared to supporters of the administration that the process of providing jobs for the unemployed and those on relief would be hastened by preventing farmers from raising such huge quantities of basic farm products as to keep down their incomes and make it impossible for them to purchase the products of industry.

It was sometimes asserted that the administration worshiped scarcity for its own sake, and was trying to make the nation rich by producing less of everything. It is obvious, of course, that in the long run a nation becomes prosperous by producing goods in abundance rather than by restricting production. We doubt, however, that the administration or economically informed people in general believed and intended that restriction in agriculture should be a permanent policy. As a temporary expedient, it may have been justified. In a severe depression, with a great industry as badly maladjusted as was agriculture, it may be desirable to practice restriction for a time in order to put the industry once more on an equal footing with other industries. When this has been accomplished, the restrictions should of course be removed, and all industries

be encouraged to move forward together toward the goal of producing an abundance of goods.

There is some question, also, as to the extent to which the administration's farm program should have been considered one of restriction. The five-year period, which was taken as a base, was one of unusually heavy production for many of these farm products. If another period had been taken as a base, full normal production, as represented by this base period, might have been permissible, or at the very least the percentages of restriction might have been much smaller. However, even with the base period which was used, the percentages by which individual farmers agreed to reduce acreage might have been decreased in some cases and increased in others. And when the time came to increase the production of basic crops in general, it might have been possible to apply different percentages of increase in different producing districts, so as to take advantage of the principle of geographical specialization to a greater extent than formerly.

At any rate, many criticisms of the farm program were apparently based upon a confusion of the terms "adjustment" and "reduction." Agricultural adjustment means the reduction of the output of farm products only when reduction is necessary. At other times, it means expansion of output or stability of output. It is difficult to see how the government could have succeeded in raising the prices of farm products and increasing farm income, without attempting in any way to exercise control over farm production. Governmental funds, used to raise farm prices, were likely to be completely wasted if the farmers were left free to produce as large crops as they might wish. Finally, with respect to scarcity, we may suggest that it was rather inconsistent for big business men and captains of industry to criticize the government severely for helping the farmers to adopt the same policy as that followed by the industrialists in every depression—that is, the policy of restriction of output.

The Loss of Freedom of Enterprise.—Much of the criticism leveled against the Agricultural Adjustment Act was based upon the so-called "regimentation" of farmers, and the loss of traditional American freedom of enterprise. Apparently the critics felt that every person should be free to become a farmer if he liked, and to raise as much as he wished of any product, even if the result was his economic downfall. Supporters of the administration, however, thought it fair to question the benefits of freedom of enterprise to the farmer. It was under the "protection" of this institution that those engaged in farming chose to be and remain farmers, despite unfavorable conditions in this industry, and it was under this same institution that they raised basic products in such quantities as to bring themselves to the verge of ruin in the great depression.

If we may judge by the response of the farmers to the administration's agricultural program, it would seem that the vast majority of them were

willing to forego a considerable measure of freedom of enterprise in return for improved prices and incomes. An objection which might be raised to this conclusion is that we do not know just how much pressure may have been brought to bear upon the farmers by federal agents, in order to get them to sign their individual contracts with the Secretary of Agriculture, or how many farmers agreed to accept benefits and restrict production because they felt they had to do so in self-defense, since other farmers were joining in the movement. In any case, this type of criticism had but little force, if the farm program was intended as a temporary measure.

The March Toward Socialism.—One of the chief criticisms of the administration's agricultural program was the tendency, clearly evident under the A.A.A., to increase the number of products to be brought under the provisions of the program as time went on. This increase may be illustrated by reference to certain sections of the South. When individual growers rented a part of their cotton or tobacco land to the Secretary of Agriculture, they had to agree not to use it for producing other basic products, such as rice; and it is not surprising that some turned to raising sugar or peanuts, when their land was suitable for such production. As a result, the price situation for growers of these articles was adversely affected, and so, in 1934, sugar and peanuts were included in the program of the A.A.A.

With five products, usually associated with the South, already under production control, in what way could the farmers use their restricted acres? There was probably no unanimity of action, but it is probable that some farmers in the South and elsewhere turned to raising potatoes. At any rate, so many potatoes were grown that some were left to rot in the ground in Maine and other areas traditionally planted to this crop. The result was the passage, in 1935, of the law for potato control. The critics held that as time went on more and more products would come under control until all agricultural production became socialized. They predicted that the movement would then turn to manufactured products, beginning perhaps with articles made from imported materials such as silk, which might compete with manufactured goods made from basic farm materials controlled by the A.A.A. They went so far as to urge that there would be no end to the process short of complete socialism.

Disclaiming all responsibility for the way in which these critics employed the term "socialism," let us examine their argument. It might be admitted that a permanent policy of control in some lines of production would tend to spread to other lines, and perhaps with undesirable results. But a policy of temporary control need not lead to permanent governmental control of all lines of production; and the A.A.A. program must be thought of as a temporary expedient. The governmental control of

prices in this country during the first World War also showed a tendency to spread to more and more articles, but it was possible to drop the whole program of price control, once the emergency was over. Arguments by analogy are dangerous, but at no time was there reason to suppose that our agricultural control program had started us on a march toward "socialism" from which there was no turning back.

The Mythical Farmers.—Much publicity was given to newspaper articles describing the payment of benefits to farmers for not raising products which they had no intention of raising. One story of this kind was told of a southern farm tenant who raised cotton in some quantity. Just before the benefit payments began, the owner of the farm dispossessed his tenant. Though the owner himself had never raised any cotton he was said to have been receiving benefits year by year for not growing cotton. There is another popular tale of the man who lived in various places, if we may accept the many versions of the story, and who used to feed hogs on the garbage collected through the exercise of a concession which he held. About 1933, he lost this garbage concession and as a consequence was retiring from the hog-raising business; but making a virtue of necessity, he proceeded to draw benefits regularly for agreeing to raise no more hogs. These particular tales may or may not be based on fact. With millions of contracts to be drawn up with individual growers, it would be surprising if there were not some instances of this kind. But it would be childish to conclude that such cases were typical of the activities of the A.A.A. Supporters of the farm program claimed that the Administration was very economical in drawing up its contracts. For example, the average 1933 yield of cotton in the United States was estimated at more than 205 pounds to the acre, but the withdrawn acres, rented by the government, were taken at an estimated 184 pounds to the acre. This low average was achieved despite the fact that the Agricultural Administration leased no land estimated to yield less than 100 pounds to the acre, and no flooded or drought-affected land.

The Farmers' Income.—When the Agricultural Adjustment Act was passed, many people doubted that the income of the farmers would be increased substantially by the program. It was expected, to be sure, that farm prices of basic products would increase; but the farmers' income depends, of course, upon prices times quantities sold. With prices to consumers raised by both reduced production and the processing taxes, it was thought that the quantities taken by consumers might fall off to such an extent that the farmer would not gain much despite the higher prices and cash benefits received. However, the statistics for farm income since 1933 leave no doubt that total farm income increased materially under the A.A.A.

The A.A.A. vs. Other Administration Policies.—It was also argued that the program for agricultural adjustment conflicted with other policies of

the Roosevelt administration—notably the attempt to increase purchasing power for consumers in general—since prices of controlled products would probably rise by more than the increase enjoyed by the farmers. This argument did not prove valid, since the farmers received benefits to offset the processing taxes and greater receipts to offset the rise in prices caused by restricted production. Hence, the only net decrease in consumers' income would seem to have been that part of the collections from processing taxes which went into paying the expenses of administering the farm program, rather than into benefits for the farmers.

It was thought, also, that total consumers' purchasing power might be reduced by reason of farmers using their income increases to pay off debts, rather than to purchase finished goods; whereas if the additions to income had not been taken away from other consumers, they would have been used to buy consumers' goods. But the indexes of farmers' purchases that we have, such as sales by mail-order houses and sales of automobiles in rural areas, seem to indicate that the farmers used no small part of their increased incomes for the purchase of finished manufactured products. And even if they did pay off old debts instead, how would their creditors use these payments, if not for the purchase of economic goods?

According to Secretary of Agriculture Wallace, the farm program was beneficial to consumers, as well as to farmers, since it was aimed to restore a "fair exchange value" for farm products and to enable farmers to purchase other goods. He insisted that consumers gain nothing in the long run by getting farm products at less than the cost of producing them. Agriculture, he said, is an essential industry which must be maintained, and to this end the prices of farm products must be kept sufficiently high to cover costs of production. He argued that consumers do not escape this necessity when for a time they fail to pay these necessary prices, but simply postpone the payment to their own disadvantage.¹

There was some strength, however, in the criticism that the A.A.A. program conflicted with the attempts of the administration to bring about recovery in manufacturing industries. The processing taxes, through which the funds were raised to pay benefits to farmers, were levied on the first processors of the farm products. They therefore operated to bring increased costs to manufacturers, and may have been a stumbling block to recovery in industries using basic farm products as raw materials.

Class Legislation.—We now turn to certain criticisms which appear to be more serious from the economic point of view. One may properly question whether it is wise at any time for the government to support a particular industry at the expense of other sections of our population and, in this case, to pay the farmers to do something which it would have

¹ United States Department of Agriculture, *Yearbook of Agriculture, 1935*, Washington, Government Printing Office, 1935, p. 5.

been to their interests to do in any case. Under the A.A.A. the consumer was taxed (if the processing taxes were shifted to him) in order to pay the farmer to restrict production and thus be enabled to charge the consumer higher prices. Clearly, the Agricultural Adjustment Act was legislation intended to benefit one class of people at the expense of others.

According to administration supporters, the wisdom of class legislation depends, at least in part, upon the length of time during which the policy of discrimination is followed. An economist who would condemn a policy of this kind as a permanent feature of our economic system might tolerate it as an emergency measure. At any rate, said the supporters, it must not be supposed that this is our first experience with legislation that benefits some members of the community at the expense of others. Our protective tariff legislation, which economists have been condemning for decades, does much the same thing, in that it benefits certain people (the owners of the protected industries) at the expense of those who are consumers. Surely it is the height of inconsistency to praise the protective tariff and at the same time to condemn the farm program on the ground that it is class legislation.

The Processing Taxes.—Was it wise to secure the funds required for the payment of benefits, by levying taxes upon the first processors of basic agricultural products? Might it not have been better to obtain this necessary revenue in some other way, so that the farmer could have received the entire benefit of the increased prices which resulted from restriction of output? In theory, at least, it would probably have been desirable to secure the revenue in some other way (say from income taxation) in order to help the farmers more extensively and to interfere less with the recovery of manufacturing industries; and also because processing taxes, if shifted to consumers, fall more heavily upon the poor than upon the rich. That is, these processing taxes were regressive. In practice, however, the receipts from income taxes and other progressive taxes are not always sufficiently elastic to produce adequate revenue in years of depression, so that it may have been necessary to use processing taxes, or other taxes similar in nature, to insure the collection of sufficient revenue.

The Administrative Problem.—There is no doubt that the farm program presented a difficult problem in administration. It would have taken a tremendous amount of supervision to make sure that all of the millions of individual farmers actually restricted their acreage by the promised amounts, that they did not turn to raising other basic products, and that they did not offset the effects of acreage reduction by cultivating their remaining land more intensively. It would seem that opportunities for petty graft abounded under the A.A.A.

Our Exports and the A.A.A.—We have noted that both the basic farm products, and the manufactured articles made from them, were exempt

from the processing taxes when they were exported. However, the prices of the exported basic products were raised by the restriction of production, and the costs of exported manufactured goods were raised, in all probability, by their dependence upon raw materials which had risen in price. Thus, our export trade was adversely affected by the farm program, and the production of the basic products in other parts of the world was stimulated to some extent.

Our cotton exports in 1934 were only 4,799,000 bales, as compared with 8,419,000 bales in 1933, and an annual average of 8,250,000 bales from 1925 to 1929. Wheat exports, which were 97,000,000 bushels in 1932, and averaged 133,000,000 bushels from 1925 to 1929, were only 19,000,000 bushels in 1934 and 3,000,000 in 1935. Exports of corn amounted to 5,000,000 bushels in 1934 and 2,000,000 in 1935, as compared with 9,000,000 bushels in 1932 and an average of 23,000,000 bushels from 1925 to 1929. Tobacco exports were 473,000,000 pounds in 1934, but declined to 353,000,000 in 1935, as compared with 432,000,000 pounds in 1932 and an average of 508,000,000 from 1925 to 1929.²

This decline in exports, however, did not seem so serious to supporters of the farm program as to some other people. Since, from the national point of view, the purpose of exporting is to become able to import, and since our imports are severely curbed by our protective tariff, a decline in exports may prevent us from making further foreign loans or getting into other difficulties in the field of international trade. Moreover, if the farm program did result in a decline in our exports of farm products, it merely continued a movement which had been in progress for many years because of our tariff policy.

The Permanence of the Farm Program.—Probably the most serious criticism of the farm program was the charge that the A.A.A., once instituted, could not be given up and would turn into a permanent policy. It can scarcely be stated too emphatically that the agricultural adjustment program was not desirable as a permanent solution of the farm problem in the United States, because it did nothing to reduce the number of farmers in the country or the amount of land available for the production of the basic crops. When the demand for a manufactured product suffers a permanent decline, the industry reacts by producing fewer units than formerly and by allowing a part of its productive facilities to lie idle. Eventually, however, the industry tends to readjust its productive capacity to the changed conditions of demand, and only then can it be said to have met the problem created by the decline in demand. The A.A.A. program led only to the first of these steps, that is, it induced

² Department of Commerce, Bureau of Foreign and Domestic Commerce, *Statistical Abstract of the United States*, 1940, Washington, Government Printing Office, 1941, pp. 729-734.

the farmers to produce less than before and to allow a part of their productive agents to remain unused. It did not lead to the apparently necessary curtailment of the land, labor, and capital employed in the agricultural industry.

The Secretary of Agriculture realized perfectly well that the A.A.A. was merely an emergency measure, that it took out of cultivation land which was efficiently cultivated as well as land which was not, and that it did not control satisfactorily the bringing of new land under cultivation and the shift of production on government-leased acres to non-basic products. According to the Secretary, the temporary and varying reductions in acreage under the A.A.A. seriously disturbed the farm economy, for it upset established rotations of crops and the relations between landlords and tenants. He suggested that it was more costly to induce farmers to keep a part of their acreage out of cultivation than it would have been to rent a corresponding acreage made up of whole farms. The purchase of submarginal land by the government would probably have been still better.³

Despite the fact that many, if not most, people felt that the A.A.A. should be merely a temporary program, there was always a possibility that it might be continued indefinitely. Once the government had established the practice of paying cash benefits to the farmers, it threatened to be a most difficult matter, from a political point of view, to discontinue these benefits when it became economically desirable to do so. Hence, we were in some danger of seeing the farm program remain as an undesirable but permanent feature of our economic system, in much the same way that the protective tariff, created more than a century ago to protect infant industries, has remained to plague us long after some of these infants have become industrial giants.

The End of the Agricultural Adjustment Program.—Arguments as to the wisdom or folly of the agricultural adjustment program came largely to an end in January, 1936, when the Supreme Court found the Act unconstitutional by a 6 to 3 vote. It was held that the law constituted an invasion of states' rights, since the Constitution did not give the federal government the power to regulate agriculture, and its power to control interstate commerce could not be stretched to include the regulation of agricultural production. Moreover, it was held to be improper for the federal government to purchase compliance with a federal program, and thus attain indirectly that regulation of local affairs which had been specifically denied it by the Constitution. While agriculture can hardly be considered a matter of local concern from an economic point of view, it appeared to be purely so according to this interpretation of the Constitution.

³ *Yearbook of Agriculture, 1934*, pp. 20-22.

THE SOIL CONSERVATION PROGRAM

The Soil Erosion Problem.—Since the federal government was unwilling to see American agriculture return to its previous chaotic state and since no permanent solution of the farm problem had been found, the government launched forth upon the discovery of a new farm program. In its search, it came upon the problem of soil erosion, upon which we commented in the preceding chapter. Satisfactory methods of combating soil erosion have been developed. Several types of close-growing vegetation, such as grass and alfalfa, are helpful in holding the soil in place and reduce water and soil losses very materially. Amazing results may be achieved merely by rotating such soil-conserving crops with the money crops, such as corn and cotton.

Results of Vegetation Control.—The Department of Agriculture has collected much information showing how vegetation may be used in preventing soil erosion. On an experimental plot near La Crosse, Wisconsin, where the soil loss was 51.5 tons to the acre when the soil was uncultivated and 59.9 tons to the acre when planted to corn continuously, it was found that the loss could be reduced to .003 of a ton per acre by planting the land to bluegrass continuously. On another plot near Bethany, Missouri, where the soil loss was 112.48 tons to the acre when uncultivated and 61.16 tons to the acre when planted to corn continuously, the loss was decreased to .22 of a ton per acre by planting to alfalfa continuously. In the La Crosse experiment, the loss of water was 15.9 per cent of rainfall when the land was uncultivated, 19.2 per cent when used for corn continuously, and only 2.9 per cent when planted to bluegrass continuously. On the Bethany plot, the water loss was 25.98 per cent of rainfall on uncultivated soil, 27.38 per cent when planted to corn, and only 3.40 per cent when planted to alfalfa continuously. Finally, in a third experiment, it was discovered that soil loss could be reduced from 28.0 to 6.3 tons per acre, and the rainfall loss from 14.2 to 11.7 per cent, by rotating cotton, wheat, and sweet clover instead of using the land continuously for cotton.⁴

Other Control Methods.—A method known as strip-cropping is also helpful in preventing soil erosion under favorable conditions of cultivation. Strip-cropping means the alternation of closegrowing crops with the money crops, such as corn or cotton, in strips of a certain width, depending on the degree of slope and other factors. This method of controlling soil erosion often requires help from mechanical methods, especially on the steeper slopes, for the land is in danger from erosion whenever it is planted to cultivated or money crops. In such cases, methods such as terracing the land and using broad, contoured channel

⁴ *Yearbook of Agriculture*, 1935, pp. 299-305.

ways for drainage have often proved helpful in reducing sheet erosion and severe gullying.

The chief difficulty with erosion control in the past has been to get the farmers actively interested in it. The individual farmer has often felt that he could do little about soil erosion by himself, or has lacked the financial resources which would permit him to make the attempt. Under unfavorable farm conditions in the past, farmers have considered it necessary to use all of their land for money crops and to keep it planted to such crops year after year, in order to make ends meet. In 1936, the government decided, after the A.A.A. was declared unconstitutional by the Supreme Court, to undertake a program of erosion control which would also help to solve the main farm problem.

The Soil Conservation Act.—Consequently, in February, 1936, a previously existing Soil Conservation Act was amended and enlarged for this purpose. The Act appropriated about \$500,000,000, and authorized the Secretary of Agriculture to restore the pre-war relationship between farm and city incomes for those farmers who agreed to practice specified methods of soil conservation and erosion control. For two years, the government was to make payments directly to cooperating farmers, as a reward for their voluntary support of the program of soil conservation. Beginning with 1938, however, federal payments were to be made only to persons in states which had passed authorizing legislation and had formed a conservation plan acceptable to the Secretary of Agriculture.

In the administration of the law, two classes of benefit payments were available for farmers who cooperated. Payments for soil conservation were granted to farmers for transferring a part of their soil-depleting base acreage to soil-conserving crops or uses. Farmers could obtain this type of payment on any number of acres up to 15 per cent of their general soil-depleting base acreage, 35 per cent of their cotton base acreage, 30 per cent of their tobacco base acreage, and 20 per cent of their peanut base acreage. The payments were on a basis of so much an acre, and averaged \$10 an acre for the country as a whole. The other payments were called soil-building payments, and were available for farmers who adopted certain approved practices to restore soil fertility, such as new seedings of legumes or perennial grasses; seedings of soybeans, cowpeas, and the like, for green manure; the application of limestone; and the use of strip-cropping or terracing methods. Such payments were limited to the same number of dollars as a farmer had acres of soil-conserving crops on crop land in 1936.⁵

The relation of this conservation program to the main farm problem is obvious. If the farmers use a part of their land for crops which will be effective in preventing soil erosion, they cannot use it for producing the basic money crops. In this way, it was planned to kill two birds

⁵ *Yearbook of Agriculture*, 1937, pp. 16, 17.

with one stone—to achieve some highly desirable results by way of controlling soil erosion, and at the same time to prevent the overproduction of the basic crops.

1936-37 Results.—The soil conservation program was in operation in 1936, but its effects on agricultural production were obscured by the great drought of that year—a drought second only to that of 1934, which is said to have been the worst in American history. The 1936 drought reduced some basic crops substantially. The cash income of our farmers, which was \$6,387,000,000 in 1934 and \$7,090,000,000 in 1935, increased, because of high prices, to \$7,850,000,000 in 1936. In 1937, weather conditions were favorable, and the output of most basic farm products was large. However, prices were well maintained, and the farmers' cash income increased further, to \$8,500,000,000.⁶

An Estimate of the Soil Conservation Act.—It seems likely that the Soil Conservation Act has a better chance for survival than the old Agricultural Adjustment Act. It has the advantage of being planned to operate eventually as a state program, carried on with financial assistance from the federal government. This procedure has proved to be constitutional in the past in other connections, as, for example, in the construction of highways. Under the soil conservation plan, the farmer is not paid for *not producing* the basic crops. Rather, he is paid for taking positive action in cooperating in a national program for soil conservation, and any restriction of output that may occur comes about indirectly. Moreover, the financing of the plan is not dependent upon a system of unpopular processing taxes. The control of soil erosion is a pressing problem, and one which is undoubtedly national in scope. Therefore, this may be judged a proper sphere of action for the federal government.

Otherwise, the Soil Conservation Act is open to many of the criticisms raised against the Agricultural Adjustment Act. It tends to make the basic farm products scarcer than they would otherwise be, and causes farmers to take a course of action which they probably would not have followed on their own initiative. It presents similar administrative difficulties, and tends to conflict with other policies of the administration. It is not quite so wide open to attack on the grounds of class legislation, since the problem of soil erosion is important to everyone; but it tends to keep the domestic prices of our farm products above the world prices, so that our exports of these goods remain at low ebb. Finally, the program may be continued far into the future, regardless of our future need for erosion control, because of its indirect effects on farm production.

These criticisms assume that the soil conservation program is effective in controlling agricultural production, but this premise may be seriously questioned. The Secretary of Agriculture has stated that the Soil Conservation Act helped to stabilize supplies of farm products in 1936,

⁶ *Statistical Abstract of the United States, 1937*, pp. 606-609.

by encouraging the more extensive use of land. But he recognized that the Act was not a direct measure for production control, predicted that the return of normal weather conditions would bring the problem of agricultural surpluses back to life, and noted that the long-run effect of soil conservation would be to increase, and not to decrease, production.

RECENT DEVELOPMENTS AND THE FUTURE

The Farm Act of 1938.—Early in the 1937–38 business recession, the prices of farm products in general slumped badly. With substantial reserves of the basic products on hand (as a result of the large crops of 1937), and with the probability of very large, if not record, crops in 1938, it appeared that further farm legislation was necessary, and so Congress approved a new Farm Act in February, 1938. This Act provides for the continued operation of the Soil Conservation Act, and its payments to farmers, in normal times. In years of overproduction of farm products, however, a rather stringent method of control goes into effect.

Acreage Allotments.—Control of agricultural production is carried on by means of acreage allotments, marketing quotas, and commodity loans. The acreage allotments are not compulsory in themselves, but they furnish the basis for setting up marketing quotas, and farmers who produce and sell the basic products in amounts exceeding their quotas must pay penalties on the excess. The national acreage allotment for each commodity is made by the Secretary of Agriculture, and is the acreage estimated to be necessary to produce a normal year's requirements for consumption and export, plus an arbitrary amount for stocks, minus the amount carried over from the preceding year. The total acreage allotment is then divided among states, counties, and individual farms. Farmers who stay within their allotted acreages receive cash benefits from the government, in addition to the benefits of the soil conservation program.

Marketing Quotas.—According to the Act of 1938, there is "overproduction" whenever the supply (crop and carryover) of a basic product exceeds "normal" by more than a stated percentage. For cotton, overproduction is any amount in excess of 107 per cent of normal; for wheat, 135 per cent; for corn and rice, 110 per cent; and for tobacco, 105 per cent. "Normal" in each case is the amount estimated to be necessary for a year's consumption and exports. When there is overproduction of any of the basic commodities, the Secretary of Agriculture may set up compulsory marketing quotas, but such quotas do not become effective until approved by two-thirds of the producing farmers voting in a referendum. The total marketing quota is defined as a year's normal consumption and exports, plus a certain percentage or allowance, minus the estimated carryover at the beginning of the marketing year and the amounts set aside for seed and livestock. The total marketing quota is prorated to

states, counties, and individual farms, in proportion to normal yields of their acreage. For the individual farmer, the marketing quota is the amount of a commodity that he may sell without incurring penalty. Moreover, basic commodities produced in excess of marketing quotas may not be fed to livestock for the market, given away, or traded for other economic goods. To avoid penalties, they must be stored on the farm or in warehouses.

Commodity Loans.—The Act of 1938 provides for loans to farmers to enable them to carry adequate reserves of basic products as a safeguard against lean years. The Commodity Credit Corporation is required to make loans on cotton, corn, and wheat, under conditions laid down in the Act, and may lend on any agricultural commodity. No loans may be made on cotton, corn, wheat, or rice, in years in which marketing quotas have been declared necessary but have been rejected by vote of the farmers concerned. In general, loans are made whenever the price of a basic commodity falls below a specified percentage of parity, or when the crop estimate exceeds a normal year's consumption and exports. The parity price for a good, as under the original A.A.A. program, is one which will give that commodity a purchasing power (in terms of goods that farmers buy) equal to its purchasing power in the base period which, for most of the goods, is the period from 1909 to 1914. Minimum loan rates are set by the Act at 52 per cent of parity prices. Farmers who do not cooperate in the quota program may receive loans only in years in which marketing quotas are in effect, only on portions of their crops whose sale would be subject to penalties under the marketing quotas, and only at rates which are 60 per cent of those extended to cooperating producers.

Crop Insurance.—The Farm Act of 1938 also provided for crop insurance for wheat only, beginning with the 1939 crop. A Federal Crop Insurance Corporation was set up, with capital of \$100,000,000 and a 1939 appropriation not to exceed \$20,000,000, to insure wheat against loss due to drought, flood, lightning, tornado, hail, winterkill, wind, plant disease, and insect infestation. The amount of insurance a farmer may carry must cover not less than 50 per cent, or more than 75 per cent, of his past average yield over a representative period of time. Premiums and benefits are payable in terms of wheat. In 1939, farmers took out some 166,000 policies covering over 7 million acres. Premiums amounted to 6¼ million bushels and insured losses to 10 million bushels.⁷ In 1940, premiums were 15 million bushels and insured losses 20 million bushels.⁸

The Farm Act in Operation.—Because of falling prices and the large 1937 crops, it was thought desirable to put the new Farm Act into immediate operation. In 1938, acreage allotments were made for all basic

⁷ *Yearbook of Agriculture*, 1940, p. 755.

⁸ *New York Times*, December 13, 1940.

crops, marketing quotas were set up for cotton and tobacco, and commodity loans were made on basic farm products and on raisins, hops, butter, prunes, wool, dates, and pecans. In spite of these measures, the crops of basic commodities were large in 1938, though not of record proportions in most cases, as is shown in Table 56. In 1939 and 1940, the crops of these

TABLE 56.—PRODUCTION OF CERTAIN BASIC CROPS IN RECENT YEARS

(Sources: *Statistical Abstract of the United States, 1940*, pp. 706-715; *Survey of Current Business*, February, 1941, p. 14; and *New York Times*, October 11, 1940)

Year	Wheat (bushels)	Corn (bushels)	Cotton (bales)	Tobacco (pounds)
1934.....	526,393,000	1,461,123,000	9,636,000	1,081,629,000
1935.....	626,344,000	2,303,747,000	10,638,000	1,297,000,000
1936.....	626,461,000	1,529,327,000	12,399,000	1,155,328,000
1937.....	875,676,000	2,651,284,000	18,946,000	1,562,886,000
1938.....	931,702,000	2,562,238,000	11,943,000	1,375,823,000
1939.....	754,971,000	2,619,137,000	11,817,000	1,848,654,000
1940.....	792,300,000	2,449,000,000	13,000,000	1,376,000,000

commodities were large, stocks on hand mounted to almost record-breaking proportions, and prices remained low, as compared with the prices farmers had to pay for other commodities. Since 1938 the provisions of the Farm Act have had ever-increasing application.

Acreage Allotments in 1941.—Acreage allotments for the basic crops in 1941 were greatly restricted. The area allotted to wheat was 62,000,000 acres, which may be compared with 64,439,000 in 1940, 63,896,000 in 1939, 79,870,000 in 1938, and 81,362,000 in 1937. In May, 1941, an allotment of 55,000,000 acres was decided upon for wheat in 1942.⁹ Again, the Secretary of Agriculture proclaimed an allotment of 27,900,000 acres for cotton in 1941, though as much as 44,000,000 acres had been planted to cotton in the past.¹⁰ The allotment for corn in the commercial corn areas of 15 states was 37,300,000 acres, or about the same as in 1940.¹¹ Similar limited allotments were set up for tobacco and other important crops.

Marketing Quotas in 1941.—Marketing quotas for basic commodities were in common use by 1941. Marketing quotas for cotton become operative when the supply reaches 107 per cent of "normal." The actual supply for 1941 was estimated at 24,900,000 bales, or 137 per cent of normal. Cotton quotas of 12,000,000 bales were announced for 1941 in September, 1940, and were approved by growers in December, 1940.¹² Quotas for

⁹ *Chicago Tribune*, May 23, 1941.

¹⁰ *Chicago Tribune*, September 19, 1940.

¹¹ *New York Times*, December 10, 1940.

¹² *Chicago Tribune*, September 19, 1940.

tobacco growers are decided upon by groups of tobacco growers, rather than by tobacco growers as a whole. In 1940, several groups voted for the establishment of three-year marketing quotas for their particular types of tobacco. The quotas for 1941 included 29,000,000 pounds of dark air-cured tobacco, 67,000,000 pounds of dark fire-cured tobacco, 292,000,000 pounds of burley tobacco, and 618,000,000 pounds of bright tobacco.¹³

Marketing quotas for wheat were not used prior to 1941, but the serious wheat situation of that year led to action. The prospect that the supply of wheat would be almost double normal requirements caused 81 per cent of the wheat farmers to vote for marketing quotas. The total quantity of wheat to be marketed under the quotas was to be determined later. The Secretary of Agriculture estimated that the supply of wheat for the marketing year of 1942 would be about 1,300,000,000 bushels, as against expected requirements of 739,000,000 bushels. He therefore announced that marketing quotas would be used again, if approved by the wheat farmers in the spring of 1942. Farmers who sell more than their marketing quotas of wheat are subject to a penalty tax of 49 cents a bushel.

Commodity Loans in 1941.—Commodity loans to enable farmers to carry heavy reserves of basic farm products were made on a large scale in 1941. Legislation passed in May, 1941, provided for loans on basic commodities as high as 85 per cent of parity prices. Loan rates that resulted were 13.49 cents a pound for cotton, 69.87 cents a bushel for corn, 96.22 cents a bushel for wheat, and 15.53 cents a pound for burley tobacco. These rates, together with benefit payments, assured cooperating farmers returns of \$1.15 a bushel for wheat, 87 cents for corn, and 16 cents a pound for cotton.¹⁴

Present Prospects.—Though basic crops have been large in the last few years, the farmers' total income has been well maintained. The cash farm income of the United States amounted to \$8,500,000,000 in 1937, \$8,071,934,000 in 1938, \$8,539,602,000 in 1939, and \$9,094,000,000 in 1940.¹⁵ However, the index numbers of prices *received* by farmers were 95 and 93 in 1938 and 1939, respectively, while the indexes of prices *paid* by farmers were 122 and 121.¹⁶ On April 15, 1941, the prices of cotton, wheat, corn, and hogs were well below parity levels, though beef cattle, tobacco, rice, and wool prices were at or above parity.¹⁷ On the whole, it must be said that the objectives of the farm program have not been fully attained. The present prospects for American agriculture are bright. The national

¹³ *New York Times*, July 21, 1940, and November 25, 1940.

¹⁴ *Chicago Tribune*, May 13, 1941.

¹⁵ *Statistical Abstract of the United States*, 1940, p. 669, and *Chicago Tribune* January 25, 1941.

¹⁶ *Statistical Abstract of the United States*, 1940, p. 673.

¹⁷ *Chicago Tribune*, May 20, 1941.

defense program led to enormous business activity, to fuller employment, and to larger total wage payments in the United States, so that farm surpluses may be reduced quite heavily as time goes on. Under the lend-lease program, our exports of farm products are likely to be stimulated. The increased demand for agricultural products will undoubtedly raise their prices, unless increased quantities reach the market.

Appraisal of the 1938 Farm Act.—Unfortunately, the 1938 Farm Act, like the two Acts which preceded it, does not provide a satisfactory solution of the farm problem. Numerous technical difficulties have interfered with the operation of the Act. National, state, and county acreage allotments and marketing quotas can usually be set up without too great difficulty, but allotments and quotas for individual farmers give much trouble. Farmers have objected to the allotments or quotas given them; and charges of favoritism and double dealing are not uncommon. It is impossible to tell how much of the alleged dissatisfaction actually exists, and how much represents anti-administration propaganda. In any event, it indicates that the 1938 Farm Act is exceedingly hard to administer. The Act is long and complicated; and it has led to the facetious remark that a farmer will need to send his son through law school if the son is to be a successful farmer himself.

The 1938 Farm Act is superior to the Agricultural Adjustment Act in that it depends upon general revenues, rather than processing taxes, for funds. Otherwise, it is quite similar to the A.A.A., except that it seems to be more highly restrictive. Practically every criticism formerly leveled at the A.A.A. may be applied to the 1938 Farm Act. Many people hold that the new Act is clearly unconstitutional. This is always a hazardous sort of prediction; but it may be said that, if this Act survives the test of constitutionality, it will be because of a changed temper on the part of the Supreme Court since the rendering of the A.A.A. decision, and not because of any inherent superiority of the 1938 Act.

The program provided by the 1938 Act is not a *long-run* solution of the farm problem. The Act sets up a complicated mechanism which may work successfully in adapting the *rate of operation* in agriculture to the demand for the products, but this is a relatively short-run type of adjustment. If the present program should be discontinued after a few years, the main farm problem would undoubtedly arise again with undiminished vigor. A long-run solution requires the adjustment of the *size or capacity* of agricultural production as a whole, and not merely its rate of operation, to the demand for farm products—and the Act of 1938 does little if anything to decrease the number of farmers or to reduce their land holdings available for growing the basic crops.

As a consequence of our entry into the second World War, the government will probably relax its restrictions on agricultural production, in order to provide reserves against our future needs and to supply farm

products to countries we have promised to help. But this will not change the nature of the present farm program, or make it a satisfactory long-run solution of the farm problem. The war situation may enable us temporarily to use all our agricultural facilities, but after the war we will still find that agriculture is overexpanded when we take into account the ordinary demand conditions for its products.

The Need for a Long-run Solution.—Our farm program should be supplemented by a careful study of land uses in the United States, to ascertain the purposes for which land in various parts of the country may best be employed. The main farm problem, it will be remembered, resulted from an expansion of farming to the point at which it could provide large exports after taking care of domestic needs, followed by the loss of foreign markets and changes in domestic conditions to which the productive facilities of agriculture have never become adjusted. Therefore, it is frequently suggested that the federal government should buy up, in different parts of the country, marginal land which was formerly devoted to the cultivation of the basic crops, and retire it from production permanently or until it is once more needed. It may be necessary, also, for the government to develop agencies to facilitate the movement of workers from farming into other occupations, in case farmers can be found who are willing to accept such assistance. These transfers would be well-nigh impossible in a period of depression, but might be accomplished eventually. It may be desirable, finally, for us to use less land for production and more for consumption, developing more national parks and using land more extensively as sites for homes.

Fortunately, progress is already being made along some of these lines, for the Resettlement Administration has been acquiring poor farming land and promoting its development for other uses. In 1936, for example, this agency obtained options on 9,500,000 acres of poor farm land in 207 projects. Most of the options were taken up at about \$4.50 an acre. The new uses for the land included forty-six recreational projects, thirty-two for the propagation and protection of migratory waterfowl, and thirty-one for the Indian service, all of which gave employment to 55,000 relief workers.¹⁸

The Tariff and the Farm Problem.—Instead of adjusting agricultural facilities to existing demand conditions, we might conceivably increase the demand for farm products so greatly that the current productive facilities of agriculture could be operated at full capacity and the output sold. Since American agriculture has been geared to serve the foreign as well as the domestic market, it is unlikely that the domestic demand alone could be increased sufficiently to accomplish this end. It would be necessary, therefore, to build up foreign markets for our farm products. If our traditional tariff policy should be thoroughly reversed when peace has

¹⁸ *Yearbook of Agriculture*, 1937, p. 23.

been restored, it might not be too late to recapture some of our former foreign markets for farm products. Our present policy with respect to the tariff, under the Reciprocal Trade Agreement Act, offers some hope that we may be able to expand our exports of farm goods when the second World War has ended.

One plan for obtaining foreign markets for our farm products after the war is already coming in for discussion. According to this plan, it is most unlikely that we shall have a general downward revision of our protective tariff which would help to solve our farm problem. Therefore, it is proposed that we lower tariff duties on certain selected foreign manufactures. The specific goods would be selected so as to do as little harm as possible to domestic industry, and the amounts to be imported would be carefully regulated. The revenue derived from the relatively low rates of duty on these special imports would be used to confer a "bonus" on foreign importers of our farm products. Such a bonus, whatever its actual form, would tend to lower the prices of our farm products to the levels prevailing in the world markets, so that foreigners could buy from us. If the scheme worked, our farmers could produce at capacity without piling up unsalable surpluses; and our manufacturers would gain more from the purchases made by the prosperous farm industry than they would lose through the increased importation of certain manufactured goods. According to proponents of the plan, our manufacturers would be better off in supplying (say) 90 per cent of a large prosperous American home market than even 100 per cent of a smaller depressed home market.¹⁹ This plan, when stated in the present somewhat oversimplified form, sounds rather attractive. In actual practice there would be almost countless difficulties to be solved.

Monopolies and the Farm Problem.—It seems, also, that a permanent solution of the farm problem depends largely upon solving the problem of monopolies and trusts. In the past, our farmers have been handicapped by having to sell their products in a highly competitive market while doing most of their buying in a market which was to a considerable degree monopolized, or at least controlled. In the long period of good business prior to 1929, many of our manufacturing industries, being monopolistic or semi-monopolistic in character, were able to maintain stable prices in the face of improved methods of production and falling costs of production. Quite apart from the effect of this situation in producing the depression of 1929, it made it difficult, if not impossible, for our farmers to get prices for their products which would enable them to share in the general prosperity of business.

Later, when the great depression broke in 1929, these monopolistic and semi-monopolistic industries were still able to maintain prices to a very

¹⁹ For a more complete statement of this plan, see C. C. Pickert and R. B. Baerman, "Is This the After-War Farm Program?" in *Country Gentleman*, November, 1940.

large extent. This they did by restricting production sharply, by turning off employees, and by reducing their purchases of raw materials. This course of action made it difficult for farmers to sell their raw materials and foodstuffs, and the uncontrolled prices of farm products had to bear the brunt of the depression liquidation. Thus, in a sense, the farmers under the recent farm programs have only been giving our industrialists a taste of their own medicine, with the assistance of the government. The farm problem would have been much less severe in the past if competitive conditions had been maintained in industry, and its solution in the future will be easier if the monopoly problem is solved successfully.

1. Did our federal government, through the A.A.A., attempt to enrich the nation by making economic goods scarce? Explain.
2. Comment on the distinction between agricultural *adjustment* and agricultural *restriction*.
3. How did the farmers react to alleged attempts to "regiment" them, through the A.A.A.? Why?
4. Was there danger that the A.A.A. program would eventually have led the nation to complete socialism? Explain.
5. Was the Agricultural Adjustment Administration extremely wasteful in carrying out its program? Explain.
6. Why was the A.A.A. program said to be in conflict with other policies of the Roosevelt administration? Explain.
7. Do consumers sometimes buy farm products at prices too low for their own good? Why?
8. Why was the Agricultural Adjustment Act called class legislation? Was it to be condemned on this account? Why?
9. Should the revenues for supporting the A.A.A. program have been derived from processing taxes? Why?
10. Could the A.A.A. program have been successfully administered?
11. How were our agricultural exports affected by the A.A.A. program?
12. What was the principal danger in connection with the A.A.A. program? Explain.
13. On what grounds was the Agricultural Adjustment Act declared unconstitutional by the Supreme Court?
14. How can soil erosion be controlled by the use of certain types of vegetation? What results have been achieved by this method?
15. What other methods are employed for controlling soil erosion?
16. What were the chief provisions of the Soil Conservation Act?
17. Explain the dual purpose of this Act.
18. Was the soil conservation program superior or inferior to the original A.A.A. program? Why?
19. Why was new farm legislation passed in 1938? Explain.
20. Compare the provisions of the Farm Act of 1938 with those of the original Agricultural Adjustment Act.
21. Explain the use of acreage allotments, marketing quotas, and commodity loans under the Farm Act of 1938.
22. Illustrate the use of these devices by reference to the 1941 program.
23. Does the Farm Act of 1938 offer a satisfactory, long-run solution of the main farm problem? Why?

24. Compare the two leading alternatives for a long-run solution of the main farm problem.
25. In what way is the farm problem related to the monopoly problem? Explain.

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CHAPTER 47

TRANSPORTATION

SPECIALIZATION and large-scale production are fundamental characteristics of the present economic order. An individual does not attempt to produce for himself all of the many economic goods he needs for the satisfaction of his wants, but instead specializes in a single task or a limited number of tasks, trusting that he may obtain, through the process of exchange, the other economic goods that he desires—goods which have themselves been produced for the most part on a large scale by other groups of specialists. Large-scale production brings with it many economies, but we often hear it said that the extent to which large-scale production (and its accompanying principle of division of labor) can be applied is largely limited by the size of the market for the products. The extent of the market is in turn greatly dependent upon the adequacy and efficiency of the means of transportation which have been or can be developed.

The Importance of the Railroads.—In the United States, as in other industrially advanced countries, the railroad has for many years been the most important single means of transportation. In 1940, there were 235,064 miles of railroads in this country, counting only single trackage between any two points, as compared with a total of 254,037 miles in 1916. If second, third, fourth, and other trackage is included in the total, the figure for 1940 was 408,350 miles. The total investment in our Class I railroads (which means every railroad that has a net operating revenue of at least one million dollars per year), including the investment in road and equipment, materials and supplies, and cash, amounted to about \$26,000,000,000 in 1940. The same group of roads employed 1,026,956 workers in 1940, as compared with 2,022,832 in 1920. Finally, the Class I railroads had revenue car loadings amounting to 36,353,609 cars in 1940, as compared with an average of 51,006,082 cars from 1926 to 1930, and carried revenue freight amounting to 373,225,000,000 ton-miles in the same year, as against an average of 427,234,000,000 ton-miles from 1926 to 1930.¹ In

¹ These statistics are from *A Yearbook of Railroad Information, 1940 Edition* (New York, Committee on Public Relations of the Eastern Railroads, 1940), and J. H. Parmelee, *A Review of Railroad Operations in 1940*, Washington, Association of American Railroads, 1941.

1939, the railroads carried 61.85 per cent of all freight transported in the United States, as compared with 17.71 per cent for inland water carriers, 11.97 per cent for pipe lines, and 8.47 per cent for motor carriers.²

Clearly, it is important to everyone that an industry of such magnitude and vital significance in our economic system should be kept strong and vigorous, and capable of rendering cheap, efficient service. And yet, since the beginning of the great depression of 1929, and even before, our railroads have not been able to earn sufficient net revenue to enable them to maintain existing plant and equipment satisfactorily and attract sufficient new funds to make possible the construction projects and betterments in general which are necessary for continued efficient operation. Indeed, many roads have failed to meet their obligations and have gone into receivership, while our railroads as a whole have operated at a net deficit, after paying interest charges, in certain years. How were the railroads brought to such a condition? What can be done to improve their lot? These are questions which we examine in the present chapter, and, in doing so, we shall find it necessary to delve into the affairs of the other forms of transportation in the United States. But our first task is to consider the chief economic characteristics of the railroads.

ECONOMIC CHARACTERISTICS OF THE RAILROADS

The railroads furnish an outstanding example of an industry which tends naturally to become a monopoly. That is, the railroad industry is one in which free competition is wasteful, if not actually ruinous, and in which maximum efficiency and lowest costs of production can be obtained only when competition is eliminated or at least greatly restricted.

Increasing Returns in Railroading.—One of the characteristics of railroads upon which the tendency to monopoly depends is what is usually called increasing returns. A railroad is a business that requires a heavy original investment. The interest upon borrowed capital, together with other fixed charges such as the rentals of leased lines, taxes, and amounts to be set aside for sinking funds to provide for maturing obligations, make up an important part of total costs of transportation, and a part which remains the same whether the railroad runs at full capacity or at only part capacity. As the traffic handled by a railroad increases, the operating costs increase, of course, but total costs do not increase in proportion to the increase in traffic, because of the large element of fixed costs. It follows, then, that as a railroad comes to be operated at full capacity, instead of at half capacity, the business that is handled doubles but the costs of transportation do not double, and, if the rates charged are assumed to be relatively constant, net earnings of the railroad increase.

² *Fifty-fourth Annual Report of the Interstate Commerce Commission*, Washington, Government Printing Office, 1940, p. 23.

There is nothing mysterious about the tendency described in the preceding paragraph, nor is the tendency peculiar to the railroad industry. Any industry which has a considerable amount of plant and equipment will find that it is more economical to run at or near full capacity, rather than at some lower level. Nor should one be led to jump to the conclusion that the railroad is necessarily one of those industries which are characterized by economists as "industries of decreasing costs." The concept of decreasing costs, as usually described in connection with price determination in the long run, is concerned with the average cost per unit of product which the industry would experience as it adjusted itself to different volumes of production *through changing the amount of plant and equipment* and other productive factors devoted to production. Thus, an industry which would have a lower average cost of production per unit when its productive capacity and amount of plant and equipment used were large than when capacity and amount of plant and equipment were small, is to be described as an industry of decreasing costs. But, with either a large or a small amount of plant and equipment, any concern in the industry would find it more profitable to run at full than at part capacity, and would experience increasing returns in the sense that a railroad may experience them. The concept of decreasing costs, therefore, refers to the experience of an industry as a whole as it changes its productive capacity, while the concept of increasing returns as applied to the railroads refers to the experience of one concern in an industry as it more or less completely utilizes a given amount of productive equipment. It may be that the railroad fits into both classes, but the one does not follow from the other.

However, the tendency to increasing returns, as described above, is of particular importance in railroading, because it is more pronounced in the railroad business than in most other lines of production. As a result of this tendency, any gain in the volume of business handled is welcomed by a railroad, while any loss of traffic is a serious matter, and consequently, under a system of competitive rates, a wild struggle for traffic usually ensues.

Joint Costs in Railroading.—A second important characteristic of the railroad business is that it operates under conditions akin to those of "joint costs." A railroad, of course, ordinarily furnishes only a single service, transportation; but a given train often carries a wide variety of articles—some of high and others of low value; some in carload lots, others in less than carload lots; some for long distances and others for short distances. The result is that the exact cost of a given unit of transportation cannot be discovered. What part of the total cost of operating a train for an 800-mile run, for example, should be charged to a ton of coal which is being carried for 63 miles in conjunction with 80 or 90 cars full of other commodities, of different values per pound, being carried for different

distances, in lots of different sizes? It follows, then, that the rates charged by railroads for their services in connection with any particular lot of goods must be more or less arbitrary, being based upon a notion as to "what the traffic will bear" rather than upon actual unit cost of production of the service.

We have already shown that the tendency to increasing returns in railroading appears most clearly when a larger volume of traffic than formerly handled is carried at approximately constant rates. Under conditions of competition, however, it does not take a railroad long to discover that it will be wise, at least from the short-run point of view, to add to its volume of traffic even if it has to reduce rates to attract the new business. As long as any new traffic will bring in enough revenue to cover the special costs of handling it, and in addition contribute something toward the costs which would persist whether or not the new business is taken on, it is profitable for a railroad to go after new traffic. Unfortunately, however, rate-cutting does not usually stop with the first cut. Unless the road with the increasing traffic has really attracted some business which would not otherwise have been carried, it has increased its own traffic at the expense of some other railroad or railroads, and one cut in rates usually leads to another, until business is being carried at rates insufficient to cover even the operating costs, not to mention the fixed costs. This process of competitive rate-cutting has often been described as "cut-throat competition."

THE DEVELOPMENT OF RAILROAD REGULATION

The American Railroad Industry Under Competition.—In spite of the fact that the railroad industry is one in which competition tends to be wasteful, the construction and operation of railroads in this country went on under conditions of practically unrestricted competition for more than fifty years. Railroads were built far in advance of the needs of the territories to be served by them, and the pressure upon the railroads, with their large unused capacities, to go out and get business, at whatever cost, was irresistible. The result was severe and destructive competition, and rate wars were of frequent occurrence. In addition, certain other pernicious practices, such as local and personal discriminations, sprang up.

Local Discrimination.—The most important type of local discrimination was that in which a given shipment of goods would be carried a long distance at a lower rate than that charged for carrying it a shorter distance. For example, as between New York City and Chicago, a low rate on a given commodity would be likely to prevail because of competition among several railroads operating between these two great terminals, while a railroad would charge a higher rate on this same good as between New York and some intermediate point at which competition with other railroads did not exist. Sometimes the rate charged to the intermediate point

was the sum of the through rate from New York to Chicago and the local rate from Chicago back to the intermediate point. So long as the through or competitive business paid for the special costs of handling it, and contributed something to the other transportation costs, it was profitable for the railroad to take it. Moreover, the rates to the local or intermediate points would not usually have been lowered if the railroad had given up the competitive business, for the local traffic would then have had to bear both the operating costs and the fixed costs in their entirety, whereas the through or competitive traffic contributed something toward the fixed costs.

Personal Discrimination.—The pressure to get business, when railroads had unused capacities, manifested itself also in personal discrimination, which means charging one person more than another for substantially the same service, or giving one person more service than another while charging the two the same rate. Favors of this sort were granted by means of a great many devices which are too numerous to note here, and were accorded chiefly to the more powerful shippers, that is, to those who had the largest quantities of commodities to be transported. The effect of widespread personal discrimination is to reduce the railroads from the status of common carriers to that of contract carriers, or carriers which undertake each particular bit of transportation service on the basis of a separate agreement as to service and rate.

Attempts to Restrain Competition.—Groups of railroads in different parts of the country at times became mindful of the ruinous nature of competition, and entered into agreements among themselves with the intent of restricting competitive activity. At times the subject of the agreements was rates, and the railroads would promise to maintain a given rate structure for a certain period of time. At other times, pooling agreements were entered into, and the railroads undertook to pool their traffic or the earnings from traffic, and to divide the business or the profits from it according to some prearranged ratio. While agreements of this sort were not punishable by law prior to 1887, they were nevertheless unenforceable at law, and there was every incentive for the railroads to attempt at times to evade the provisions of the agreements. As a result, most of these agreements did not enjoy long life.

Early Railroad Regulation.—The disastrous effect of competition on the railroads, the complaints of shippers concerning local and personal discrimination, the fear of monopoly power under rate and traffic agreements, the speculation and fraud which pervaded railroad finance, and the attitude of railroad officials and executives toward the public, were some of the causes which influenced Congress to begin a long career of railroad regulation by passing, in 1887, the Act to Regulate Commerce. The legislation pertaining to the railroads has been constantly changing since that time, but it was only after almost thirty-five years of regula

tion that anything like a constructive approach to the railroad problem was adopted in our railroad legislation. It will be impossible in this chapter to analyze in any detail the provisions of the various Acts which have been passed in regulating the railroads, but it is essential to an understanding of the railroad problem of today that the chief defects of the early railroad legislation should be pointed out. The two principal defects were closely related to each other.

The Negative Character of Early Legislation.—One defect of our regulatory scheme prior to the last twenty years was that it concerned itself chiefly with provisions intended to keep the railroads within bounds, and to prevent the exploitation of the public through unreasonable transportation charges and arbitrary maladjustments in rate relationships. The principal aim of regulation was to wipe out railroad abuses, and consequently most of the provisions of the legislation took the form of prohibitions. For example, the railroads were warned that they must not discriminate between persons or companies, must not charge more for a short haul than a long haul unless granted specific permission, and must not enter into agreements for the pooling of traffic or earnings. From a positive point of view, not much was said as to what the rates should be. Our legislation did provide, of course, that rates should be "just and reasonable," but no significant meaning was given to these terms prior to the legislation passed in 1920. In short, the early railroad legislation treated in detail the things that the railroads should not do, but paid little or no attention to what they should do if the country was to have an efficient national transportation system. The items which were omitted from the regulation, rather than those which were included, seem to us to constitute the primary purpose of regulation.

The Policy of Enforced Competition.—Though attempts were made, as was stated above, to eliminate some of the worst abuses which sprang up under competition, there was a continued insistence on competition as the condition under which the development of our railroad system should go on. "The anti-pooling clause of the Act to Regulate Commerce, and the prohibitions of the anti-trust laws as judicially applied to the railroads, created serious practical obstacles to the development of responsible relations between the carriers, to the elimination of personal preferences, to the stabilization of competitive conditions, to the achievement of such economies as coordination might render possible, and to the full and flexible utilization of the available plant and equipment. This condemnation of cooperative effort among the carriers through insistence upon the rigorous enforcement of competition; despite the subversive tendencies of such competition in the direction of rate fluctuations and discriminatory practices, and despite the difficulties of maintaining uniform charges among competitors of strikingly unequal strength, was but a reflection of the primary emphasis of the regulatory scheme upon re-

straining the potential overreaching of quasi-monopolistic power rather than upon the provision of a satisfactory system of transportation.”³

The Railroads and the First World War.—Because of the nature of our railroad legislation, its application brought results which were, in many respects, undesirable. We spent too much time seeing to it that railroad rates were not unreasonable or discriminatory, and gave too little attention to the question of efficient railroad transportation and to providing the railroads with a rate system which would permit them to earn a sufficient amount to enable them to attract into the industry the capital so necessary for continued efficient operation. Consequently, when the heavy traffic of the first World War began to make unparalleled demands upon our railroads, they were unable to respond adequately. During this great national emergency, the wastefulness of competition in railroading and the importance of having an efficient national system of transportation were fully realized for the first time.

In order to avoid the complete breakdown of our system of railroad transportation which seemed imminent, the federal government undertook to operate the railroads during the participation of the United States in the first World War, and for some time afterward. It was impossible, of course, to revolutionize the railroad industry and transform it instantly from a disorganized and inadequate competitive system into an efficient national organization, but many steps were taken during the period of federal operation which augured well for the future. The railroads were operated “as a national system of transportation, the common and national needs being in all instances held paramount to any actual or supposed corporate advantage.”⁴ Locomotives and other rolling stock were pooled and used as necessity dictated, without regard to ownership. Shipments of freight were moved to their destinations by the most direct routes regardless of the wishes of shippers as to routes or the amount of use made of any particular railroad in the process. Certain railroads were compelled to share their terminals with other railroads, and repair shops were used jointly. Cars were loaded heavily and the demurrage rates, or charges for leaving freight in the railroad cars in excess of a reasonable length of time, were increased to speed up car unloadings. Passenger service was cut down, and consolidated ticket offices were introduced. The purchase of materials and supplies was centralized, new equipment was standardized, expenses for advertising were reduced, and valuable uniform statistics were compiled.

Whatever conclusion may be reached as to the financial or operating success of the federal control of the railroads, we may at least be thankful for the new attitude toward the railroads which prevailed after the

³ I. L. Sharfman, *The Interstate Commerce Commission*, New York, Commonwealth Fund, 1931, part 1, pp. 79, 80.

⁴ *Ibid.*, p. 155.

ment, and operation, subject to two conditions: (1) The Commission must approve the proposed consolidation as being in line with its final consolidation plan, and (2) the par value of the bonds and stocks of the new consolidation must not exceed the value of the consolidated properties as determined by the Commission.

As a temporary expedient, pending the adoption of the final consolidation plan, it was provided that the Commission could permit one railroad to acquire control of another railroad or other railroads, by means of leases, stock purchases, or any method not involving actual consolidation. In addition, while agreements for the pooling of freight or net earnings were still held to be unlawful in and of themselves, it was provided as another temporary expedient that the Interstate Commerce Commission could approve such agreements and render them valid, or even go to the length of taking the initiative in bringing them about.

The Benefits of Consolidation.—The benefits, from a social or national point of view, which might be expected to result from the consolidation of the railroads of the country into a limited number of systems as provided in the Act of 1920, are familiar ones. First, they would make it possible to realize important economies in operation and to utilize to the maximum the existing plant and equipment of the railroads, by methods similar to those employed by the federal government during its operation of the roads. These methods would include, of course, the pooling of locomotives and cars and their use anywhere in the system, the joint use of terminals and other facilities, heavy loading of cars, centralized purchases, standardized equipment, and uniform statistics. In the second place, the consolidation plan would replace numerous existing lines, of varying financial condition and command over traffic, with a small number of systems of approximately equal strength. As a result, rate regulation would be facilitated.

Rate Provisions of the Act of 1920.—Congress, in drawing up the Transportation Act of 1920, was mindful of the necessity for adequate earnings in railroading and tried to make provision in the Act for rates which would make such earnings possible. The Commission was given the power to establish both maximum and minimum rates and, by fixing both, to decide upon the actual rates. Furthermore, it was made the duty of the Commission to exercise its rate-making powers in such a way that the railroads as a whole, or as a whole in such rate groups or territories as it might designate, would earn an aggregate annual net railway operating income equal, or as nearly equal as might be, to a fair return upon the aggregate value of the property of such railroads used in the transportation service. The valuation of the railroad property, and the determination of what constituted a "fair rate of return" upon such property, were to be in the hands of the Commission. In determining such fair rate of return, the Commission was to bear in mind the transportation needs of the coun-

try and the necessity of expanding railroad facilities, if adequate transportation was to be furnished. It will be noted that no provision whatsoever was made for individual railroads to earn a fair rate of return. It was only for the railroads as a whole, or in certain groups as designated by the Commission, that fair returns were to be sought. The word "group" in this connection may, we believe, be taken to mean a group of railroads somewhat larger than one of the limited number of systems into which the railroads of the country were to be consolidated.

The Recapture Clause.—It was realized, of course, that rates high enough to give a fair rate of return for the railroads as a whole or in large groups would furnish some strong roads enjoying good location and excellent physical condition the chance to make an excessive rate of return. The "recapture clause" in the Act of 1920 was intended to provide against this contingency. According to the provisions of this clause, any railroad which received in any year a net railway operating income of more than 6 per cent on the value of its property devoted to transportation was required to share the excess above 6 per cent with the government. One-half of the excess income was to be turned over to the Commission for the purpose of setting up what was called a "general railroad contingent fund," while the other half was to be held in a reserve fund by the railroad. When the amount in this reserve fund equaled 5 per cent of the value of the railroad's property, the fund could be drawn upon, but only to meet fixed charges and make dividend payments in years when its net operating income fell short of the 6 per cent level prescribed by law. The general railroad contingent fund, on the other hand, was to be used by the Commission to make loans at 6 per cent interest to needy railroads, for the purpose of developing equipment or refunding maturing obligations, or to buy railroad equipment and lease it to the railroads.

Railroad Securities Under the Transportation Act of 1920.—A third division of the Act of 1920 concerned itself with the control of railroad securities. The principal purpose of such control was to make sure that the financial operations of the railroads in the future would be of such a nature as to provide a sound basis for the rehabilitation of railroad credit and for the development of the railroad system. In addition, it was desired to protect the investing public against loss through extravagant and even dishonest financing, such as had taken place at times in the past. The principal provision of the Act, with respect to securities, was to make it unlawful for railroads to issue their own securities or to assume any obligations in connection with the securities of other railroads unless, after their application to the Commission and after investigation by the Commission of the purposes and uses of the proposed financial operation, the Commission should give its consent. The Commission was given rather wide discretionary power in deciding these financial matters, but it was asked to bear two considerations in mind: (1) The proposed transaction

must be for some lawful purpose within the business of the railroad, and (2) it must be reasonably necessary and appropriate for this purpose.

Service Regulation.—The fourth major problem touched upon by the Act of 1920 was that of adequate railroad service. Each railroad was ordered to furnish safe and adequate car service, and to set up and enforce reasonable rules and practices with regard to such service. Car service was taken to include the supply and use of rolling stock, the supply of trains, and interrailroad relationships with regard to rolling stock. The Commission was also empowered, when it considered such action desirable, to formulate reasonable rules and regulations to govern the railroad car service. In case of emergency, the Commission could abolish all existing regulations with regard to car service, and proceed (without regard to the desires of any particular railroads) to provide for the unified utilization of railroad facilities, for the joint use of terminals, for preference or priority for certain commodities in transportation, and for direct routing and expeditious handling of traffic.

Finally, the approval of the Commission had to be obtained before an existing railroad enterprise, or any part of it, could be abandoned, or any new construction of railroads undertaken. Furthermore, in this connection, the Commission was again given power to take the initiative, and order a railroad to provide itself with safe and adequate facilities for carrying on its car service, or to extend its lines by means of new construction.

Progress Toward Consolidation.—Though the Transportation Act of 1920 represented a refreshing and desirable change of attitude toward the railroad problem, it did not furnish a satisfactory basis for the operation of the railroads in the years after its passage. In the first place, comparatively little progress has been made toward the consolidation of the railroads. It is true, of course, that the Commission in 1921 published a tentative plan which provided for the consolidation of the railroads of the country into nineteen systems. One system was to provide for the needs of New England, five were to be trunk-line systems between New York and Chicago, and five were to be transcontinental systems from Chicago to the Pacific coast. The lower Michigan peninsula was to have one system, and there were to be two "soft coal" lines from the Chesapeake Bay to the Great Lakes. Finally, there were to be three systems in the Southeast and two in the Southwest. Extended hearings were conducted to consider the plan, but little has been done toward putting it into operation. However, several railroads have been allowed to carry out plans for consolidation with other roads or for the acquisition of control over them as provided in the law.

It must be remembered that consolidation cannot be forced upon the railroads by the Commission under the present law, and consolidation has not gone forward at a very rapid pace. In the first place, the strong rail-

roads, in good physical condition and with undoubted earning power, have been unwilling to join forces with the weaker roads to form the type of systems called for by the Act of 1920, or at any rate to go into such consolidations except on terms rather unfavorable to the weak roads. And in some cases, the railroad officials who would naturally carry on the negotiations for consolidation have not been anxious to do so for fear they might be forced to accept positions in the new system inferior to those which they already hold.

The Control of Railroad Securities and Service.—The provisions of the Transportation Act relative to railroad securities and service have not been of great practical importance up to the present time. Since 1920, and especially since 1929, railroad earnings have been low and railroad credit has not rated so high as in former times. The carriers have consequently experienced considerable difficulty in refunding their maturing obligations on satisfactory terms, and new issues, for many roads, have been practically out of the question. The control of railroad service by the Commission has been a source of irritation to railroad executives. They complain of the situation as one in which a company cannot extend its facilities if business is profitable, or abandon production if business results in large net losses, without the approval of a governmental commission, and in which a company may be asked to share its facilities with competing companies.

Railroad Earnings Since 1920.—The most serious criticism of the Transportation Act of 1920 is that under its operation railroad earnings have never been entirely satisfactory and sank to a very low level after 1929. Apparently many people thought that the Act had disposed, for many years to come, of the problem of securing adequate railroad earnings, but a study of the net operating income of the railroads since 1920 discloses that this was decidedly not the case. The rates of net operating income of the Class I railroads of the United States, based upon the aggregate value of their property devoted to the transportation service from 1921 to 1940, are shown in Table 57. It should be noted that the percentages there presented are for Class I railroads as a whole, and are calculated upon the valuations which the railroads themselves put upon their properties. If calculated on the basis of the Commission's valuations of the railroad properties, they would be slightly higher, because the latter valuations have ordinarily been somewhat more conservative than those of the railroads themselves.

While it is difficult to say what rate of return upon the aggregate value of railroad properties would be adequate, and no more than adequate, for the maintenance of an efficient transportation system, we may at least point out that the rates actually earned by the railroads since 1920 have been consistently below the rate determined upon by the Commission as one which it considered adequate and reasonable. The Commission de-

TABLE 57.—THE RATE OF RETURN EARNED BY CLASS I RAILROADS AS A WHOLE, UPON THE AGGREGATE VALUE OF THEIR PROPERTY DEVOTED TO THE TRANSPORTATION SERVICE, 1921-40

(Sources: *Statistics of Railways of Class I, 1930*, Washington, Bureau of Railway Economics, 1935; *A Yearbook of Railroad Information, 1940 Edition*, p. 50; and *A Review of Railway Operations in 1940*, p. 28)

1921.....	2.87%	1931.....	1.99%
1922.....	3.59	1932.....	1.21
1923.....	4.33	1933.....	1.82
1924.....	4.23	1934.....	1.78
1925.....	4.74	1935.....	1.93
1926.....	4.96	1936.....	2.57
1927.....	4.28	1937.....	2.27
1928.....	4.61	1938.....	1.43
1929.....	4.81	1939.....	2.25
1930.....	3.28	1940.....	2.61

cided in 1922 that, for the railroads as a whole, a rate of 5% per cent upon the aggregate value of the railroad properties used in the transportation service would be adequate; and it will be remembered that under the Act of 1920 the "recapture" of the earnings of individual railroads was to begin at 6 per cent. If the Commission's figure of 5% per cent is accepted as satisfactory for the railroads of the country as a whole, it is clear that the railroads, even in the period of relatively good business between 1921 and 1929, did not earn an adequate rate of return in any year.

Railroad Finances in the Depression.—In the post-1929 depression, with its sharp decline in the volume of goods requiring transportation by any agency, the railroads were very hard hit. The net earnings of Class I railroads fell from 4.81 per cent on the aggregate value of their property in 1929 to the ridiculously low figure of 1.24 per cent in 1932. Since 1932, the "peak" in railroad earnings occurred in 1940, when a rate of 2.61 per cent was achieved. It may be noted, however, that the 1940 earnings amounted to 3.43 per cent when computed on the basis of value as found by the Interstate Commerce Commission as of January 1, 1938. The earnings rates which we have presented are for net operating income *before the payment of interest charges*. After paying interest charges, the Class I railroads had net deficits in 1932, 1933, 1934, and 1938, and had very small net incomes in other recent years.

The number of passengers carried by these roads, which had averaged 1,114,055,000 annually from 1916 to 1920, declined to 432,980,000 in 1933, and the revenue freight carried, which had averaged some 427,234,000,000 ton-miles from 1926 to 1930, fell to 233,977,000,000 ton-miles in 1932.⁵ Railroads have failed in large numbers in recent years. By the end of 1940, 104 railroad companies with 75,765 miles of track were in re-

⁵ *Statistical Abstract of the United States, 1935*, pp. 368-375.

ceivership or trusteeship.⁶ This mileage represented 31 per cent of the total for the United States. Even heavier casualties would probably have occurred had it not been for the activities of the Reconstruction Finance Corporation and Public Works Administration in lending \$987,579,305 to the railroads during these troubled years. Of this sum, \$376,386,271 had been repaid by the railroads by the end of 1940.⁷

THE CAUSES OF THE RAILROAD PROBLEM

The Problem of "Fair Valuation."—While the desperate situation of the railroads in recent years is largely chargeable to the post-1929 depression, the rise of competing forms of transportation and defects in rate-making and rate regulation were also contributing factors. The Transportation Act of 1920 directed the Interstate Commerce Commission to use its rate-making powers in such a way that the railroads as a whole, or in groups designated by the Commission, would earn a fair return on a fair valuation of their properties devoted to the transportation service. This rule of rate-making sounds eminently fair, but it is difficult to apply. To begin with, what is a "fair valuation" of the properties of railroad companies? The use of the value of industrial properties as the basis for determining what earnings should be granted the owners exactly reverses the customary economic procedure. For the value of productive facilities ordinarily *depends upon the earnings* which the owners are able to make with their help. The *earnings* are capitalized at the current rate of interest, and this capitalization is the *value* of the productive facilities. Clearly, the valuation of the railroad properties for rate-making purposes had to be made on some other basis.

To many persons, the *cost* of the railroad properties seemed to suggest their value, but the application of the cost formula was also difficult. Should the value of a railroad's properties be the amount actually spent in acquiring them, or should it be what would have to be spent, at the time of valuation, for new properties with equal productive capacity? If original cost, and not reproduction cost, is decided upon, should the original cost include all expenditures actually made by the railroad, or merely an amount which it would have been "prudent" or "necessary" to spend? The principle of a fair return upon a fair valuation has lost much of its significance for railroading since 1933, and does not warrant a detailed examination at this point. It will be considered more fully in our treatment of public utilities in the following chapter.

The Problem of a "Fair Return."—The Transportation Act of 1920 provided for the recapture of the earnings of individual railroads in excess of 6 per cent on the valuation of their properties, and the Interstate Commerce Commission decided that 5½ per cent was a "fair rate of return."

⁶ *A Review of Railway Operations in 1940*, pp. 9, 10.

⁷ *Ibid.*, p. 11.

To make 5% per cent on the aggregate value of their properties over a period of years, the railroads would have to make higher earnings in some individual years, since they would certainly make less in others. It was possible, of course, for individual railroads to net more than 5% per cent in some years, by sharing with the government the earnings in excess of 6 per cent; but the rates which the railroads as a whole could charge for their services appeared to be adjusted in such a way that no more than the prescribed fair return would be earned by them as a whole in any year, while in some years the rate was certain to be less than that established by the Commission. This situation appears to be inconsistent with any satisfactory long-run interpretation of a fair rate of return.

Other Experiences with the Rule of Rate-making.—The rule of rate-making of the Transportation Act of 1920 was unfortunate in that it gave many people the idea that expert rate-making by the Commission would insulate the railroads against the effects of booms and depressions in general business, and afford the railroads a stable rate of return year by year. Such hope has been shown to be entirely unrealizable by the events of recent years. The rule of rate-making apparently created, also, a disposition on the part of railroad executives to place complete responsibility on the Interstate Commerce Commission whenever the railroads failed to make a fair rate of return. Finally, the rule of rate-making has been shown to be a will-o'-the-wisp in a period of rapid technological change, such as that which has prevailed in the transportation field in recent years. Such technological changes usually require important readjustments in the industries affected, and may impose severe losses on established producers in the field. The investments which were made in the railroad industry may have appeared necessary and sound when they were made, but the rise of other forms of transportation appears to have rendered a part of the railroad facilities unnecessary and obsolete. Under such conditions, it may be impossible to set up any rate structure which will afford the railroads a fair rate of return on the entire actual investment which they made in their productive facilities, and it would seem logical to revalue the railroad properties so that the earnings which it is possible for the railroads to make will constitute a fair rate of return.

The Demand for Railroad Services.—Some years ago, when the railroads provided the only satisfactory means of long-distance transportation, they could count on carrying most of the passenger and freight traffic of the country. In other words, the demand for their service was inelastic. Under this condition of demand, high rates for passengers and freight tended to yield better financial returns than low rates, and a rate increase could usually be depended upon to increase railroad earnings, if additional income was necessary.

But in recent years, motor vehicles and other carriers have developed into efficient and satisfactory agencies of transportation. Consequently,

the country is no longer absolutely dependent upon the railroads and, for some types of traffic, can take the railroad service or leave it, depending upon the comparative rates and service of the railroads and other transportation agencies. Hence, the demand for railroad service is now relatively elastic. Under this condition of demand, high rates may prove financially disastrous to the railroads, while low rates may bring increased business and improved net earnings.

Some events of recent years suggested that many railroad executives had failed to recognize the changes that had taken place in transportation, and continued to think of the service provided by railroads as absolutely essential. When railroad traffic and earnings declined rapidly after 1929, the railroads in 1931, 1935, 1937, and 1938 petitioned the Interstate Commerce Commission for increases in freight rates. Some of the requests were granted and some rejected, but the increases in freight rates were not very helpful in the face of poor business conditions, the small total volume of traffic, and strong competition from other types of carriers. The conservatism of railroad officials also manifested itself in the slowness with which they adopted improvements in railroad equipment and service, and by their opposition in 1936 to the Commission's decision to reduce railroad passenger fares in the hope of increasing traffic earnings.

The Railroad Labor Situation.—Another factor operating to accentuate the railroad problem is the favorable treatment which the railroads have been required by law to afford the workers in the industry. The federal government, in carrying out its policy of railroad regulation, has not hesitated to raise the status of labor in the industry. In 1916, the average railroad employee worked 3151 hours for an income of \$891.61, or 28.3 cents an hour. In 1940, the average employee worked a little over 2547 hours for an income of \$1913, or 75.1 cents per hour. Hence, he worked 19 per cent less time in 1940 than in 1916, but received wages amounting to 114 per cent more. The total wage bill of the railroads was almost 34 per cent greater in 1940 than in 1916, while the total number of employees was about 38 per cent smaller.⁸

The railroads are compelled by law to maintain safety appliances for the protection of their workers, and the employees, of course, receive free transportation from the roads for which they work. They also receive various financial benefits under such laws as the Railroad Retirement Act and the Railroad Unemployment Insurance Act. Recent proposals for the benefit of railroad workers include the payment of the same wages for six hours' work a day as are now paid for eight hours, and dismissal compensation for employees affected by abandonments or unifications of railroads. While these advantages may not be greater than the railway employees should enjoy, they have unquestionably constituted a heavy bur-

⁸ *Ibid.*, p. 33; and *A Yearbook of Railroad Information, 1940 Edition*, pp. 62-66.

den upon the industry in times of depression. On this account, a general 10 per cent reduction in railway wages was permitted, and became effective February 1, 1932. However, the 1931 level of wages was completely restored by April 1, 1936.

Competition in Transportation.—Probably the principal factor giving rise to the railroad problem was the loss of passenger and freight traffic to automobile and water carriers, both before and during the post-1929 depression. To be sure, the figures we have cited for 1939 show that the railroads were still carrying 62 per cent of all freight in the United States, as against 26 per cent for motor and water carriers combined. However, the railroads in 1939 handled less than 9 per cent of the passenger traffic, of which almost 91 per cent moved in busses or private automobiles.

After many years and much legislation of the trial and error variety, we eventually arrived at the significant conclusion that consolidation and cooperation of railroad lines are preferable to their competition as a means of obtaining efficiency and economy. However, we have been slow to realize that it is equally likely that coordination and cooperation of the several types of carriers—rail, water, motor, and air—would be better than competition, from the point of view of developing an adequate and efficient national system of transportation. Of course, not all of the railroad traffic losses were due to the competition of other types of carriers. Moreover, the railroads have no legitimate grievance in connection with the loss of traffic to other types of carriers, so long as the traffic gains of these carriers are based on superior service, more efficient operation, and lower costs. But the railroads have often charged that traffic has been taken from them by unfair competition. Into this question we must look a little further.

Water Competition.—There can be no doubt that there is a place for water carriers in our transportation system, but the railroads have complained that much of the traffic handled by water carriers was secured on the basis of costs that were low only because of special advantages and favored treatment received by these carriers—treatment not accorded the railroads. In other words, it is contended that the competition furnished by some water carriers is essentially unfair to the railroads.

Certain inland waterways have been constructed at heavy cost to the federal government, and have proceeded to charge shippers rates so low that the receipts would barely cover the operating expenses of these water lines. When this sort of thing takes place, the shippers, of course, are not paying the full costs of transportation, but are being subsidized because the taxpayers assume the expenses for fixed charges and maintenance. The railroads, on the other hand, must maintain tracks, bridges, and terminals, and pay their own fixed charges and taxes. Thus, they not only lose traffic to these waterways, but pay heavy taxes as well, part of which

go to the support of the waterways, their competitors. Incidentally, the taxes paid by Class I railroads in 1940 amounted to \$396,000,000, or about 58 per cent of their net operating income of \$682,000,000, before paying interest charges.⁹

To take an extreme example, let us consider the Mississippi-Warrior Rivers Barge Line. It has been estimated that the government spent 600 million dollars on this system and its branches. Since its construction as a war project, this barge line had carried, up to 1929, 7½ million tons of freight at an average annual loss, borne by the taxpayers, of \$440,000; and this figure is said to include no allowance for ordinary interest, taxes, and depreciation, such as a private transportation enterprise would have to meet.¹⁰ More recently the Inland Waterways Corporation, operating federal barge lines on the Mississippi River and tributary waterways, reported that in 1939 it had carried 1,894,916 tons of freight at a net loss of \$299,949, even though it paid no taxes or interest to private investors.¹¹ Not all water carriers, of course, can be compared directly with these lines; but it is probable that a considerable portion of the freight carried by water, amounting annually to many millions of tons, is carried at rates insufficient to cover total costs of production, if interest, maintenance expenses, and the taxes which would be collected from strictly private transportation agencies are included. This situation is clearly a cause for concern to the railroads.

Motor Competition.—The competition of motor carriers has also been serious. Not only do large numbers of people transport themselves from place to place by automobile, but common carriers by bus have also made a hole in the passenger traffic receipts of the railroads. In addition, large quantities of freight are now being carried by truck, both for short and for long distances. Some of the trucks operate as common carriers; that is, they run over regular routes at certain specified times and serve all comers. Others operate as contract carriers, furnishing each bit of transportation service on the basis of a separate agreement as to conditions of transportation, including rates, between the trucking company and the customer. Finally, some companies, engaged in other lines of business, do their own trucking.

The Advantages of Motor Carriers.—Again, the railroads had no thought of contending that there is no place in our transportation system for carriers by motor, but they claimed that much of the competition furnished by these carriers was unfair to the railroads so long as motor carriers were unregulated as to rates and other conditions of service, and enjoyed special advantages that were not available to the railroads in

⁹ *A Review of Railway Operations in 1940*, p. 26.

¹⁰ E. E. Loomis, "Railways vs. Waterways," in *Review of Reviews*, February, 1929, pp. 79-82.

¹¹ *Chicago Tribune*, May 28, 1940.

furnishing their transportation service. First, with regard to the alleged advantages enjoyed by motor carriers, it was pointed out that they are largely exempt from certain types of expense which the railroads have to bear. The roadbed for the motor carriers is the public highway, constructed and maintained at public expense, and the fixed charges on the investment in these highways are not paid by these carriers.

The motor carriers have shown that the heavy taxes which they pay are enough, or more than enough, to cover their share of the cost of constructing and maintaining the highways, but this is not quite the point. The motor carriers pay taxes, but these taxes represent their only contribution to the cost of constructing and maintaining their roadbed—the public highways. The railroads, on the other hand, claim that they have to construct and maintain their own roadbed, and in addition pay taxes which are at least as heavy as those paid by motor carriers. This claim must be discounted somewhat on the ground that rights-of-way, extra land, and in some cases money were given to the railroads by various governmental units many years ago.

In the second place, the railroads complained that the motor carriers were almost completely unregulated, since they were relatively free to charge any prices they liked for their services, while the railroads were not free to make changes in their rates to meet motor competition. Changes in railroad rates could be made, of course, but only slowly and with the consent of the Interstate Commerce Commission, and consequently the rates could not be made flexible enough to meet the rapid changes in rates open to the unregulated motor carriers. A truck owner could take a load a certain distance at a remunerative rate and, rather than return with an empty truck, could afford to pick up a return load at almost any price obtainable. With some exceptions, he could charge different people different rates for exactly the same service. He could charge more for a short than for a long haul, and was subject to almost no restrictions as to adequacy or regularity of service, being permitted to enter or quit the business at will. None of these advantages were enjoyed by the railroads. To have permitted competition between motor carriers and the railroads to continue on the terms described above, would have been to sanction a condition which was fraught with danger for the railroad industry, and to make it extremely unlikely that the railroads, being closely regulated, could earn a return adequate to insure continuous, efficient transportation service.

SOLVING THE RAILROAD PROBLEM

The Federal Railroad Coordinator.—As a result of the depression and other factors affecting the railroad problem, the railroad industry was in a woeful condition when the Roosevelt administration took office in

March, 1933. This administration, however, lost no time in trying to assist the railroads. It was thought that part of the railroads' difficulty in obtaining adequate revenue was due to their failure to effect the economies which had been expected to accompany consolidation. As we have seen, consolidation had moved at a snail's pace since 1920, and the independent railroads did not cooperate in such a way as to reap any considerable part of the benefits which were expected to result from consolidation. Therefore, in 1933, a law was passed creating the office of Federal Coordinator of Railroads, which office was filled by Joseph B. Eastman, former member of the Interstate Commerce Commission. The duties of the Coordinator were (1) to encourage and promote, or require, the elimination of unnecessary duplication and waste, and (2) to recommend further legislation for the improvement of transportation conditions.

The Accomplishments of the Coordinator.—The Coordinator made practically no use of his power to order the railroads to introduce economies. The first two years of his term of office were largely given to making surveys, and comparatively few of his plans were so perfected that he felt justified in requiring the railroads to adopt them. Besides, it was felt that the efficient administration of his office depended on securing the cooperation of the railroads and that they should be encouraged to adopt the plans voluntarily. Among the subjects studied were the joint use of terminals, box-car pools, improvements in handling merchandise traffic, joint railroad shops, a central research bureau, and the development of new containers, or sectional car-bodies, interchangeable between all railroads and with other types of carriers, to be used for store-door pick-up and delivery service.

Recommendations were finally made to the railroads regarding some of these matters. The pooling of freight cars by the railroads would have resulted in a saving of \$100,000,000 a year in interest and operating expenses, according to the Coordinator, while the joint use of terminals would have saved \$10,000,000 a year in Chicago alone and \$50,000,000 in the country as a whole. These and other suggestions were in general unfavorably received by the railroads. Apparently there was a feeling that the Coordinator was trying to "show up" the railroad executives and force reforms upon them. The executives held that the savings suggested by the Coordinator would be almost completely offset by the cost to the railroads of complying with new railroad legislation recommended by the Coordinator. Moreover, it was held that the greater part of the anticipated savings would involve reductions in the railroads' labor force, although the law provided that the number of railroad employees must not be reduced by coordination. In view of the hostility of railroad executives, and the desire of those in favored positions to hold their advantages, it is hardly surprising that the Coordinator did not meet with much success in his efforts to bring about the coordination of the railroads.

The office of Federal Railroad Coordinator was discontinued in 1936, but the Transportation Act of 1940 set up a Board of Investigation and Research for the transportation field as a whole. The Board has three members, appointed by the President, and a statutory life of two years with a further extension of two years at the option of the President. The work of the Board falls into three general categories: (1) It is to study the extent to which public aid is given to rail, motor, and water carriers, and the taxes which are paid by these carriers to the various governmental units. (2) It will examine the relative economy and fitness of these types of carriers, to determine the kinds of work for which each is especially suited and methods for developing the carriers into an adequate national system of transportation. (3) It has the power to investigate or consider any other matter relating to these transportation agencies which it thinks may improve transportation conditions and effectuate the national transportation policy declared in the Interstate Commerce Act.

Compulsory Coordination or Consolidation of Railroads.—Investigation and research are valuable, but their results must be used if practical benefits are to be obtained. After twenty years in which little has been accomplished in the way of coordination or consolidation in the railroad industry, it is sometimes proposed today that we should gain one or the other of these objectives by compulsion. Under such a plan, the Interstate Commerce Commission would be given the power, after mature deliberation and extended hearings, to order such coordination or consolidation as might appear desirable from the point of view of securing efficient railroad operation. In some instances, either coordination or consolidation might appear to be contrary to the corporate interests of individual railroads, but it is argued that the private interests of individual railroads should be subordinated to the interests of the country as a whole in developing a sound national transportation system. It is said to be, after all, only a step from the Commission's present authority to control the extension of railroad lines and services, to the power to order the consolidation of certain railroad properties. Moreover, it is argued that the railroads themselves would probably prefer compulsory consolidation to governmental ownership and operation, which might be seriously considered if efficiency in transportation cannot be achieved under regulation.

Rate-making and the Recapture Clause.—In 1933, the recapture provision of the Transportation Act of 1920 was repealed. This clause, it will be remembered, required individual railroads to turn over to the government one-half of their net operating income in excess of 6 per cent on the value of their properties devoted to transportation, and to place the remainder of such excess earnings in a reserve fund. The recapture clause had been a source of great annoyance to the railroads, though it probably was not a serious financial burden in view of the generally low railroad earnings since 1920. The clause seemed to be inconsistent with the de-

clared principle of allowing the railroads to earn a fair return, in the long-run sense of that term, and we believe its repeal should be permanent.

The general rule of rate-making was also changed by the Transportation Act of 1933, and the emphasis is no longer placed simply on the "fair return on a fair valuation" as in the Act of 1920. The new principle provides: "In the exercise of its power to prescribe just and reasonable rates the Commission shall give due consideration, among other factors, to the effect of rates on the movement of traffic; to the need, in the public interest, of adequate and efficient railway transportation service at the lowest cost consistent with the furnishing of such service; and to the need of revenues sufficient to enable the carriers, under honest, economical, and efficient management, to provide such service." Though this new principle is somewhat less definite than the old one, it will probably furnish a more satisfactory general basis for rate regulation.

Passenger Rates.—The Interstate Commerce Commission, through its control of both maximum and minimum railway rates, holds the power to decide what passenger and freight charges are to prevail. In 1936, the Commission decided to investigate the effects of reduced passenger rates. It ruled that the basic passenger fare should be changed from 3.6 cents to 2 cents a mile in coaches, and to 3 cents in Pullman cars; and also eliminated the 50 per cent surcharge on Pullman service. It was hoped that these reductions would bring an increase in passenger traffic which would more than offset the lower fares, and thus yield the roads a greater net income from passenger traffic. The results of this experiment cannot be stated very definitely. Railroad passenger traffic picked up sharply under the low rates, but before the full effects of the reduced charges could be thoroughly tested, the business recession of 1937-38 brought an upset to all calculations.

The reduced fares affected only the eastern railroads, since the roads in other parts of the country had already reduced their passenger fares. In July, 1938, the Interstate Commerce Commission permitted the eastern roads to raise the basic passenger fare from 2 to 2½ cents a mile, and these roads promptly made the change. The increased rate was experimental, however, and in February, 1940, the Commission denied a petition by most of the eastern roads for the continuance of the rate. Over strong opposition of the petitioning railroads, which threatened to carry the matter to the Supreme Court, the Commission ruled that the basic passenger coach rate must return to 2 cents a mile as of March 24, 1940. But the Commission later, as of February 10, 1942, authorized a 10 per cent increase in both coach and Pullman car railway fares.

Improvements in Railroading.—In the past few years, the railroads have manifested a highly progressive attitude toward their business. Some have adopted streamline trains for certain routes, and these trains have both increased the speed and convenience of the service and lowered

the operating costs. Most roads have installed air-conditioned passenger cars, and made other changes in equipment which have increased the comfort and convenience of railroad travel. Many have also inaugurated what is called a store-door pick-up and delivery service, to make the railroad freight service comparable to that furnished by motor carriers, and have in some cases begun to operate their own trucks and busses. In 1940, 66 leading railroads announced a new scheme to increase passenger business by selling railroad tickets on the installment plan. The plan operates through a separate company, called the Travelers' Credit Corporation, and applies only to trips costing \$50 or more. Applications for credit are passed on overnight; the customer gets his ticket and takes his trip; and payment is made in monthly installments. Such a wide-awake attitude on the part of the railroads is likely to be much more conducive to a solution of their problems than their former "standpat" attitude.

Railroad Wages.—In May, 1938, the railroads decided to reduce the wages of their employees by 15 per cent, effective July 1, 1938, but later changed this date to December 1, 1938. Declining revenues and increased expenses of operation had combined to make the railroad situation even more serious than in 1932, and the roads determined upon a wage cut in the hope of saving some \$250,000,000 annually. The leaders of the railroad labor unions immediately announced that the cut would be resisted. No agreement could be reached through direct negotiation between labor and management, and the services of the National Mediation Board were requested in August, 1938. The Board was unable to mediate the dispute. The President then appointed a fact-finding committee to report on the problem. The decision of this commission was not binding on either labor or management, and for a time it seemed likely that there would be a strike; but in November, 1938, the railroad executives decided to withdraw the proposed wage cut. In 1941, the railroad workers demanded a 30 per cent wage increase. After extended discussion, attempts to mediate, and threats of a strike, the unions and the management reached an agreement, on November 5, 1941, which called for an average increase of 12½ per cent in the wages of railroad workers.

Financial Reorganizations.—Some railroads have found a partial solution to their problems in financial reorganization. The Transportation Act of 1920 did not give the Interstate Commerce Commission complete control over reorganizations, but 25 railroads reorganized under the Bankruptcy Act of 1933, and thus reduced their long-term indebtedness by roughly 1½ billion dollars and their interest charges by \$91,000,000 annually.

The Motor Carrier Act.—Another important accomplishment in the transportation field was the passage, in 1935, of an Act to regulate motor carriers. The Act did not actually become operative until several months of 1936 had elapsed. While this legislation was not intended primarily

if, after holding hearings, it finds that rates do not comply with the law, it may prescribe new rates.

For purposes of enforcement, a division of four members of the Commission was created to supervise all matters pertaining to motor vehicles. Under this division, a motor carrier bureau was established with district offices in various parts of the country. Violations of the law are subject to a \$500 fine for a first offense, and \$2000 fine for each additional offense. These penalties apply to both shippers and carriers. The common carriers must give bills of lading for goods transported, and the carrier which first handles a shipment is responsible to the shipper for any loss, damage, or injury caused by it or any other carrier, but the first carrier has a claim upon a subsequent carrier if the fault lies with the latter. The Commission controls security issues, consolidations, mergers, and acquisitions of control in the industry, and may recommend additional legislation. It is also authorized to investigate and report on the need for regulations as to the size and weight of motor vehicles.

At the very outset of the operation of the law there was considerable confusion. Motor carriers filed tariffs and then requested immediate changes. In some cases they failed to collect the published rates and fares, and did not make their tariffs available for public inspection. Sometimes the rates announced by carriers differed considerably from those announced by their authorized agents, and the carriers complained grievously about one another. It is clear that there are considerable practical difficulties to be overcome in enforcing this law, because there are so many operators and because the business of many motor carriers is by no means so regular, well established, and easy to supervise as that of the railroads.

Motor Rates and Rail Rates.—It has been common practice for motor carriers to disregard the traditional railroad principle of basing freight rates on what the traffic will bear. They have usually charged flat rates for transporting freight without regard to the value of the articles and the rate classes in which the railroads classified them, or have charged a flat rate at least for articles in the first three classes of the railroad freight classification. This practice developed from the high degree of competition in the motor carrier industry, which led operators to emphasize the *cost of service* rather than *value of service*. Its effect was the diversion of a considerable amount of freight traffic in articles of high value from the railroads to the motor carriers.

The railroads adopted a number of devices to meet this situation, the simplest of which was to lower freight rates on individual articles, reclassify such articles, or grant exceptions to classifications. Again, they developed "all-freight" or "all-commodity" rates for carrying freight, usually in carload lots, without regard for the classifications of individual articles that made up the shipments. These all-freight rates are now

more than three commodities at one time, the control of common and contract water carriers was placed in the hands of the Interstate Commerce Commission. The Commission may prescribe maximum, minimum, or specific rates; and has control over the entry of firms into water carrier service, consolidations of firms, security issues, accounts, and other matters which it controls in the case of rail and motor carriers. With the passage of the Transportation Act of 1940, only air carriers were left outside the control of the Commission. The rapidly growing air transportation industry may soon need to be brought under the jurisdiction of the Commission, but for the present the matter does not seem to be of great importance, since the air carriers transported no freight in 1939 and handled only one-fourth of one per cent of the passenger traffic of the country.

The National Transportation Policy.—The Transportation Act of 1940 was also noteworthy for its statement of a national transportation policy. It said: "It is hereby declared to be the national transportation policy of the Congress to provide for fair and impartial regulation of all modes of transportation subject to the provisions of this Act, so administered as to recognize and preserve the inherent advantages of each; to promote safe, adequate, economical, and efficient service, and foster sound economic conditions in transportation and among the several carriers; to encourage the establishment and maintenance of reasonable charges for transportation services, without unjust discriminations, undue preferences or advantages, or unfair or destructive competitive practices; to cooperate with the several States and the duly authorized officials thereof; and to encourage fair wages and equitable working conditions;—all to the end of developing, coordinating, and preserving a national transportation system by water, highway, and rail, as well as other means, adequate to meet the needs of the commerce of the United States, of the Postal Service, and of the national defense. All of the provisions of this Act shall be administered and enforced with a view to carrying out the above declaration of policy."

Certainly no one can quarrel with the general objective of fair and impartial regulation of all modes of transportation, but there may be some question as to what the objective involves. To many people, it would mean similar if not identical regulation of carriers by rail, motor, and water; but there are some reasons for believing that this approach is unsound. Carriers by water and motor are in general numerous and rather small, in comparison with the railroads. Their investments in plant and equipment and their fixed costs are smaller than those of the railroads, and the tendency to increasing returns is less pronounced. Motor and water carriers are not so likely, therefore, to engage in rate-cutting and cut-throat competition to attract additional traffic. It is somewhat easier for them, than for the railroads, to ascertain the cost of carry-

be effected, since the federal government can borrow on its own bonds at a lower rate of interest than that charged the railroads as private corporations. As the result of efficient operation and the fact that profits would no longer be necessary, rates could be lowered, and the centralized control over rates would insure the disappearance of personal and local discriminations.

Incidentally, it is held that the relations of the government to labor in the railroad industry would be more harmonious than those which have prevailed in the past between railroad labor and the railroad corporations, and that losses would no longer be sustained because of the activities of dissatisfied employees. Investors in railroad securities would also be benefited through the substitution of governmental obligations for those of the railroad corporations and the elimination of the question of railroad failures and receiverships. Finally, it is pointed out that the majority of the railroads in the world outside of the United States are owned and operated by governments, and that the trend appears to be in the direction of government ownership, rather than away from it.

The Case for the Continuance of Regulation.—Despite this imposing array of arguments, there is something to be said on the other side of the question. So far as the stated objective in railroad operation is concerned, there is, we believe, a clear case for governmental ownership and operation; but whether this objective would be realized in practice depends upon a number of other considerations, not the least of which is the efficiency of management under governmental operation. Even if we grant for the moment an efficiency of management under governmental operation comparable to that under private operation, is it likely that any great gain would be realized from the fact that the profit motive would no longer predominate? So far as the past is concerned, it is certain that the welfare of the people of this country would not have been greatly enhanced by the capture and devotion to public purposes of the profits made by the railroads since 1920. The total investment in the Class I railroads of this country amounted in 1940 to over 26 billion dollars. While the government would probably take over the railroads at something less than the railroads' own valuation of their property, it is probable that over 20 billion dollars' worth of government bonds would have to be issued for the purchase of the railroads. The railroads now have to pay fixed charges only on their bonds, since income to the stockholders is contingent upon net earnings, while under government ownership the total investment in the railroads would be represented by bonds upon which fixed charges would have to be met. On the other hand, the rate of interest would be less upon these obligations than upon those of the railroads. The probable result would be, then, that the fixed charges which the government would have to meet would be in the aggregate somewhat less than the total of fixed charges and dividends which would

The inability of governmental railroad management to avoid recurring deficits is said to be a strong argument against governmental ownership and operation, for our private railroads have paid as high wages and have given as efficient and comfortable service as the government-owned railroads, in spite of the excessive operating expenses of the latter.

Again, in the matter of rate discriminations, it does not seem that governmental ownership and operation would help. Personal discriminations have already been eliminated for the most part, and local discriminations might easily continue under government ownership. Who would want railroad rates to be adjusted between the different parts of the country by the same method as that which is used in distributing tariff favors? To go a step further, who would want expenditures for the maintenance and improvement of the railroads to be granted to the various districts of the country upon the same basis as that which is now used in passing out appropriations for the improvement of rivers and harbors, and the construction of post offices, court houses, and other public buildings? Political influence in railroading would endanger the efficiency of our transportation system.

From our war-time experience with governmental operation, it seems reasonable to suppose that the government might succeed in establishing more friendly relations with labor than those which exist at present between the railroad corporations and railroad labor; but it is to be feared that the new condition would be brought about through the payment of such high wages that railroad employees would become a favored class, to the prejudice of other members of the community. Finally, it appears that the interests of the holders of railroad securities can be as well protected under regulation as under government ownership.

Such are the arguments which are commonly advanced for and against the governmental ownership and operation of the railroads. It is not our function to suggest to the reader the final conclusion to be arrived at out of this welter of opposing arguments, for it is the privilege and duty of a citizen to weigh the evidence pro and con and reach a decision for himself. Indeed, it is important that a decision be reached fairly promptly by our voters, for the matter of governmental ownership and operation of railroads may easily become the question of the hour in the relatively near future.

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1. Why are the railroads important in our present economic system?
 2. What is the nature of the "railroad problem"?
 3. What is meant by saying that the railroad industry is one of increasing returns? How does the concept of increasing returns differ from that of decreasing costs?
 4. Why are the railroads said to operate under conditions akin to those of joint costs?

5. Under what condition did the railroad industry operate during the early years of its life in this country? What abuses sprang up in connection with the railroads during this period? Why?
6. In what respects was the early legislation affecting the railroad industry defective? Explain fully.
7. What adjustments, in railroad operation were made necessary by the first World War? Why?
8. Why does consolidation in the railroad industry appear desirable?
9. What were the provisions of the *Transportation Act of 1920* with regard to consolidation? What progress toward consolidation has been made under this law?
10. How did this Act undertake to control railroad service and the issuance of railroad securities?
11. What were the provisions of this law with respect to railroad rates and earnings? Explain.
12. How were railroad earnings affected by the Act of 1920?
13. How did the railroads fare in the depression years of 1929 to 1933?
14. Discuss the difficulties involved in applying the principle of a "fair rate of return on a fair valuation."
15. How was the "recapture clause" related to the problem of obtaining a fair rate of return for the railroads? Explain.
16. What change has apparently taken place in the nature of the demand for the services of the railroads? How has this change been related to the railroad problem?
17. "In general, the rule of rate-making provided by the Act of 1920 has proved unsatisfactory in practice." Discuss.
18. What was the significance of the railroad labor situation in connection with the railroad problem?
19. To what extent was the railroad problem due to the competition of other transportation agencies? Explain.
20. Why was the competition of motor and water carriers characterized as *unfair by the railroads*? Were the *contentions of the railroads with regard to this competition* sound? Explain.
21. Discuss the activities and accomplishments of the Federal Railroad Coordinator. What was the attitude of the railroads toward his work, and why?
22. Why do some people now urge compulsory coordination or consolidation of the railroads?
23. What happened to the rule of rate-making and the recapture clause in recent legislation?
24. "The railroads will probably make greater net earnings from passenger traffic with low fares than with high fares." Discuss.
25. What improvements have recently been made in the equipment and operation of the railroad industry?
26. Discuss the present railroad labor situation.
27. Summarize the main provisions of the Motor Carrier Act of 1935.
28. How have motor and railroad freight rates been changing in recent years?
29. How were the regulatory powers of the Interstate Commerce Commission extended by the *Transportation Act of 1940*?
30. "If carriers by rail, motor, and water are to be treated fairly and impartially, they should all be regulated in the same way and to the same extent." Discuss.

31. Why do some people contend that the only real solution of the railroad problem is to be found in governmental ownership and operation? Explain.
32. Why are others quite as firmly convinced that governmental ownership and operation of the railroads should be avoided? Explain.

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- SHARFMAN, I. L., *The Interstate Commerce Commission*, New York, Commonwealth Fund, 1931-1938, Parts 1, 2, 3, 4.

the total revenues expand considerably. Consequently a public utility company undertakes to get as much business as possible and, when two utilities offer the same service to the same customers, their relations often degenerate into cut-throat and destructive competition. Such a condition, marked by violent rate-cutting, is likely to last until one company is ruined or absorbed by the other, or until the competitors see the light and agree to combine. Even if competition were as economical as monopoly in these businesses, it might still be desirable to have some of them operated as monopolies. In telephone service, for example, it is important, in the interests of convenience, for all telephone users to be subscribers in a single company, rather than to have them distributed among several companies. As a result of these and other considerations, governmental units have come to recognize the need for monopoly in such businesses, and have permitted and even encouraged monopoly operation.

Essential Products.—A second characteristic of public utilities is that their products, whether services or commodities, are generally regarded as vitally necessary to the public. In our large cities, thousands or hundreds of thousands of people look to surface, subway, and elevated railway lines for transportation, and their dependence upon other public utilities, such as electric companies, is so great that a stoppage of service, even for an hour or two, may lead to considerable inconvenience or even to genuine suffering. In the field of communication many individuals and businesses depend largely upon the telephone or telegraph service. In general, the demand for public utility services is inelastic. To be sure, the demand for (say) gas, on the part of some users at least, may be elastic because of the existence of satisfactory substitutes, but the demand for heat, light, or power in some form or other is relatively inelastic.

Franchises.—A third characteristic of public utilities is that many of them are dependent, for the right or power to operate, upon privileges or favors granted them by the public through various governmental units. Street railways, and water, gas, and electric companies, must use public streets or highways; or the areas above or below such streets and highways, in the conduct of their business, and are given grants, or "franchises," by state and local governments for this purpose. Moreover, governments sometimes grant public utilities the right to condemn private property for necessary purposes or to use public water power in their business.

Differential Rates.—A fourth characteristic of public utilities is that a company, such as one supplying electric current, is usually permitted to sell its service to several classes of consumers for different purposes at different prices. It is quite impossible to determine the *exact* cost of supplying the service to any particular class of consumers and, as a result, the rates charged are likely to be arbitrary and to be based upon "what the traffic will bear."

THE REGULATION OF PUBLIC UTILITIES

With public utility businesses operating as monopolies in their particular areas, producing essential economic goods for which the demand is relatively inelastic, and depending in many instances upon special privileges or favors granted by the state, it is clear that the unregulated operation of these businesses by private enterprisers might result in great evils, including extortionate rates for inferior service and unfair discrimination between different consumers or classes of consumers. The possibility of operation of an anti-social nature led to early regulation of public utilities—so early, indeed, that the problems connected with public utilities were almost completely local in character, and their regulation could scarcely have been assumed to fall within the constitutional powers of the federal government. As a result, the regulation of public utilities has been conducted largely by the states.

Public Utilities Commissions.—This regulation has not ordinarily been undertaken directly by state governments. Rather, the regulatory powers have been delegated to commissions. Some of the better-equipped public utility commissions have powers similar to those exercised by the Interstate Commerce Commission in regulating the railroads. They often control rates and fares, extensions and abandonments of service, the issuance of securities, the prevention of undue discrimination between different customers and classes of customers, the quality of the service, the valuation of utility properties, and accounting methods. Of all these many items, the most difficult and important is, of course, the regulation of rates.

The Regulation of Rates.—The states, and their public utilities commissions, were at first left quite free to regulate the rates charged by public utilities. The courts, including the United States Supreme Court, refused to interfere with what was so obviously an exercise of powers granted to state governments by the Constitution and would neither set aside prescribed rates nor themselves set up rates for the utilities. Eventually, however, the court attitude changed and the Supreme Court decided that if rates set by state governments or their commissions were so unreasonable as practically to destroy the value of the properties of public utilities, they could be set aside as violating the "due process" clause of the federal Constitution. Thereafter, the commissions, while trying to protect the interests of consumers, have been kept from setting public utility rates at so low a figure that they would be confiscatory with respect to the properties of public utilities; and the general idea has developed that rates should be regulated in such a way as to enable the utilities to earn a "fair rate of return on a fair valuation of their properties."

The Problem of Valuation.—It is all very well to say that the utilities

should be allowed to earn a fair rate of return on a fair valuation of their properties, but quite another matter to apply the principle to specific cases. The first difficulty is to establish a fair valuation. The property of a public utility scarcely has a value, in the usual economic sense of exchange value, since it is seldom bought and sold and is hedged about with restrictions and regulations which do not affect ordinary property. The value of a piece of industrial property is usually determined by the income it is capable of earning. But in the case of public utilities, earnings depend upon rates and these rates (if they are to represent a "fair return") cannot be set until after the "fair valuation" has been determined. Therefore, the commissions have had to turn to other methods of evaluating the properties of public utilities. The problem of valuation has usually been approached by way of "prudent investment cost" and "reproduction cost."

Prudent Investment Cost.—Prudent investment cost is ordinarily taken to mean the amount of capital actually invested in a public utility enterprise, corrected for capital expenditures dishonestly made or made in a clearly wasteful or extravagant manner. There are several possible ways of arriving at prudent investment cost. It is sometimes said that the par value of the stock of a public utility represents satisfactorily the amount of the actual investment in the business. This criterion, however, could not be applied to all public utilities, since some have issued stock with no par value. Moreover, there may be only a vague relationship between the par value of a utility's stock and the actual value of its property. Some public utilities are overcapitalized, and have outstanding an amount of stock well in excess of the value of their properties. For example, a public utility company, just starting in business and short of cash, may wish to acquire a piece of property without paying cash for it. To induce the owner to accept stock in lieu of cash, the company may have given him stock which has a par value well above the cash value of the property that is being acquired. Of course, to allow public utilities which are overcapitalized to earn a fair return on their capitalization would be to grant them an excessive return on the actual value of their property.

Again, the par value of a company's stock may at one time have represented accurately the value of its property, but no longer do so because through poor management the utility has lost some of its original assets or had them depreciate in value. Or the property of a company may increase in value without the increase being reflected in the amount of capital stock outstanding. In either case, a fair rate of return on the basis of capitalization would give a return on the actual value of the property which was either larger or smaller than it should be. Consequently, capitalization has little to recommend it as a basis for valuation.

Another proposal is to assume that the market value of a public utility's

ance? How can we prevent companies from padding their costs, if original costs are used as the basis for valuation? These and other questions suggest that there is considerable room for error in estimating original cost.

Even if it should be possible to ascertain original cost accurately, there is no assurance that this method of valuation would be fair to public utility companies and investors at all times, since it does not take into account changes in the general price level. The original cost method gives a fixed valuation to a public utility company's property, and a fair rate of return on this valuation means a relatively fixed money income. In a period of falling general prices, this stable money income would give increased purchasing power to the company and its stockholders, and impose a correspondingly heavy burden on the consumers, while in periods of rising prices it would bring decreased purchasing power for company and stockholders, and the consumers would be obtaining public utility services at bargain prices. This objection is not so serious as it sounds, however, for public utility commissions do not guarantee the utilities a stable money income. They merely try to regulate rates so that utilities will *normally* make a fair rate of return on the value of their property. Even if the rates are not reduced in a period of falling prices, the volume of business done at these rates will likely decline to such an extent that a utility's real income will not be enhanced unduly; and if rates are not raised in a period of rising prices, the increased volume of business at these rates may serve to keep the utility's real income from declining severely. However, the long-time upward or downward trends in general prices may serve to affect, either favorably or unfavorably, the purchasing power of the income received by public utility companies.

It is also said that the original cost method of valuation tends to discriminate between the consumers of the services of different utility companies. If one company's plant was constructed and its property acquired at a time when prices and costs were high, its consumers would have to pay rates sufficiently high to give the company a fair return on its high original cost. At the same time, the customers of another utility may be charged much lower rates because this company's plant was constructed and its property acquired at a time when prices and costs were low. Finally, the original cost method, when first introduced, may work a hardship upon persons who have bought the stock of public utility companies because of the high actual earnings of the companies and high returns paid on the stock. When the companies are subsequently limited to earning a fair return on the original cost of their properties, the dividends may be sharply reduced so that the stock will decline in value and deprive the owner of a part of his investment.

Reproduction Cost.—The principal alternative to the use of prudent investment cost for valuation purposes is valuation on the basis of the reproduction cost of public utility properties. In applying this method, the

cost of reproducing or replacing a company's properties is estimated and this figure is adjusted for depreciation, or the supposed difference in value between the actual properties and similar new properties. Of course, if the properties are not allowed to depreciate, an adjustment is not necessary. Valuation on the basis of reproduction cost is a more recent development than valuation on the basis of original cost, and is more flexible and therefore more readily adjustable to changing business conditions. Moreover, it is said to be in stricter conformity with the dictates of economic theory. Since business enterprisers ordinarily plan future production on the basis of prospective prices and prospective costs, rather than upon the basis of costs incurred in past production, it is held to be more logical to evaluate public utility properties for rate-making purposes on the basis of reproduction cost, rather than original cost.

However, it is difficult to get a definite valuation by the method of reproduction cost, for several obstacles stand in the way. Should reproduction cost be taken to mean the cost of constructing identical productive facilities or substitute facilities which would have the same total productivity? Should it be estimated as under present conditions and methods of construction or under methods and conditions which existed when the company's productive facilities were constructed? What would it now cost to acquire the company's franchise or build up the good will which it developed in the past? These questions are more readily asked than answered, and in the absence of satisfactory answers the proper valuation of a company's properties on the basis of reproduction cost is a debatable matter.

The flexibility of valuation on the basis of original cost may be an advantage or a disadvantage. When the general price level falls, the cost of reproduction falls also, so that a lower valuation for a property is appropriate, while the reverse is true in a period of rising prices. Assuming that the rate of return remains unchanged, the money income of the company will decline as the purchasing power of money increases and increase as the purchasing power of money declines, so that the real income of the company and its stockholders should remain fairly constant. In general, a fluctuating money income and stable real income would be preferable to a stable money income and fluctuating real income. However, this adjustability means that the valuation of a company would never remain stable for any great length of time, since it would change with changes in the general price level. As a result, a company's valuation would be constantly in a state of flux and neither the company nor the regulating commission would have anything definite to go on. The cost of reproduction method is advantageous in that it does not discriminate between the consumers of different utility companies, as does the original cost method; for two substantially similar plants would probably be given approximately the same valuations on the basis of re-

production cost, however different their original cost may have been because they were constructed at different times and under different cost conditions. Furthermore, the use of reproduction cost is likely to cause plants to be built efficiently and at low cost, since original cost will not affect valuation or earnings, while under the original cost method there is an incentive to make the original cost high for valuation purposes. However, on the whole, the weight of opinion favors the original cost interpretation of prudent investment cost as the basis for public utility valuation.

The Fair Rate of Return.—In addition to deciding, upon some basis or other, the valuations to be placed upon the properties of public utility companies, public utility commissions have to decide upon a fair rate of return on these valuations. This, also, is a difficult matter. The commissions must protect the public against the monopoly powers of public utilities, but at the same time the companies must earn enough to cover costs of production, so that they may render efficient service, maintain their productive facilities, and attract new capital for purposes of expansions and improvements. Moreover, in addition to deciding the rate of return they would like the utilities to earn on the basis of their valuations, the commissions must determine the prices for services which are most likely to produce the desired rate of return for the utilities, keeping in mind the uncertainty of business conditions and possible variations in the cost of producing the services. A given set of prices will produce different rates of return for different companies with identical valuation if the managements of the companies differ in efficiency. While problems of valuation and fair rate of return have attracted more attention than the problem of arriving at prices which will bring in the fair rate of return on the fair valuation, this latter problem is a very trying one.

Public utility valuation and rate regulation are so complicated that they are often dealt with in complete volumes, but enough has been said in the present chapter to enable the reader to appreciate their difficulty. Under the circumstances, it is not surprising that attempts by several agencies to determine the fair valuation and fair return for a public utility company have resulted in valuations which varied by hundreds of millions of dollars, and in proposed earnings in which the largest exceeded the smallest by 100 per cent.

Another Method of Rate Regulation.—The difficulties of the fair-return-on-the-fair-valuation approach are so great that in some cases commissions have abandoned this method of regulating rates and adopted what might almost be called a rule-of-thumb method. In Massachusetts, for example, the commission is said to take into consideration principally the economic situation of the company. It considers whether the company is paying dividends on its stock, whether the stock is selling at or above par on the market, whether the company is providing adequate deprecia-

power to other utility companies at less than cost, and to industrial users at but little above cost, while charging domestic or residential consumers from fifteen to twenty times the average cost of generating and transmitting the current.¹

Weaknesses of the Commissions.—While the regulatory problems faced by the commissions are very complicated, it is probable that much of the ineffectiveness of regulation has resulted from the inadequacy of the powers granted to some commissions and to defects in their personnel. The commissions control only electric light and power companies in two of the states. Gas companies are controlled by commissions in 40 states, water companies in 39 states, street railways in 40 states, and telephone and telegraph companies in 44 states. Only about two-thirds of the states have granted their commissions the authority to prescribe a uniform system of accounting for public utilities, and yet, without something of this sort, it is almost impossible to determine the facts needed for valuation and rate-making purposes. In only one-half of the states do the commissions supervise the issuance of securities by utilities, and in fewer still do they exercise any real control over the uses made of the funds derived from the sale of securities.

Members of the commissions are elected by popular vote in 16 states, although it would seem that positions requiring so high a degree of technical knowledge might better be filled by appointment. The commissions themselves are made up of three members each in 36 states, and consequently are often too small for effective work. In a few cases the functions of commissions are not clearly defined in the state laws, and many commissions are handicapped by reason of insufficient funds. In 1929, for example, total state expenditures for the regulation of both public utilities and railroads amounted to only \$7,200,000.² Despite these weaknesses, the commissions have done much by way of setting up standards of service and safety for the utilities, although, as was previously stated, they have not been especially successful with respect to valuation and rate-making.

Interstate Public Utility Activity.—Two recent developments in the public utility field have conspired to make state regulation of the industry less effective than formerly. Many years ago, the business of the public utility was almost entirely local in character; but at present the services of a utility are often sold, at least in part, in other states than the one in which the company is located. Electric power is the public

¹ C. D. Thompson, *Confessions of the Power Trust*, New York, E. P. Dutton & Co., Inc., 1932, pp. 216-227.

² The statistics on public utility commissions are from C. M. Clay, *The Regulation of Public Utilities*, New York, Henry Holt & Company, Inc., 1932, pp. 144-149; and C. W. Thompson and W. R. Smith, *Public Utility Economics*, New York, McGraw-Hill Book Company, Inc., 1941, pp. 197-206.

utility product which enters most largely into interstate commerce. This interstate business has created a curious "no man's land" of regulation. The Supreme Court has held that state commissions have no power to regulate rates or other matters in the case of electric power sold at wholesale by a company in one state to a company in another state for distribution in the latter. However, when a company in one state sells a public utility service directly to consumers in other states, the Court has ruled that such business may be regulated by the states unless and until the federal government itself attempts regulation. These interstate activities of public utility companies are pretty clearly a part of interstate commerce and subject to federal control, but they are a complicating factor in state regulation.

The Development of Holding Companies.—Another factor which has arisen to hamper state regulation of public utilities is the development of holding companies. Holding companies, as we shall see, may exert a tremendous influence for good or evil in the public utility field, but they are scarcely amenable to state control. They are connected with the public utility industry only through owning, directly or indirectly, a controlling interest in the stocks of actual public utility operating companies. Since they produce no utility services themselves, they do not come under the jurisdiction of public utility commissions; and, since many of them operate in two or more states, they have not been readily controlled by the individual states. The problem of the holding companies has become so important that in 1935 the federal government made an attempt to control them and their activities. Before considering this attempt at federal control, we must look into the organization and practices of these companies.

HOLDING COMPANIES

The Nature of Public Utility Holding Companies.—Any company which holds the stock of other concerns may be called a holding company, but the term is usually reserved for companies that own a controlling interest in the stock of other companies and actively direct the affairs of these corporations. In the public utility field, a "first-degree" holding company is a corporation that owns a controlling interest in the stock of one or more operating utilities (those which really produce and sell electricity or some other service to the public) and that directs the business activities of the operating company or companies. A "second-degree" holding company will own a controlling interest in the stock of one or more "first-degree" holding companies, each with a group of operating companies under its control. Similarly, there may be holding companies of "third degree," "fourth degree," and so on. Holding companies, of course, are not limited to the public utility field. They exist in many of our major in-

dustries, but the problems which they present are probably of greatest significance in the field of public utilities; and it is primarily in this field that holding companies above the first degree are found.

The Financial Functions of Holding Companies.—The champions of holding companies in the public utility field claim that many advantages result from the operation of these corporations. A principal function of holding companies is to furnish capital to operating companies. Public utilities require a heavy investment in fixed capital, and much new capital is needed from time to time for extensions and improvements. Public utilities in towns and small cities have often secured from local sources the funds with which to start in business, but they have often found it difficult to raise funds for extensions and improvements. They have been in a poor position to appeal to investment bankers for funds to be obtained through the issuance of securities, because they were small and unknown and lacked diversity of resources. In this connection, holding companies have been of assistance. They have accepted the securities of the small operating companies in exchange for needed funds, later recovering their outlay by marketing their own security issues, which were readily salable because the holding companies were comparatively large and well known and possessed resources (through the operating companies) which were well diversified in both character and location. Even when the security market has not seemed to be in condition to absorb new securities, the operating companies have often obtained funds from their holding companies by direct loans. Through the operation of holding companies, the individual operating companies are able to secure capital on better terms than those on which they could secure it for themselves. It is claimed that such financial support has helped to improve the quality and reliability of service in small communities, and to replace small, inefficient plants with large, modern generating stations.

Other Holding Company Functions.—Another benefit credited to the holding company is its ability to save money for its operating companies by acting as their purchasing agent. By purchasing at one time machinery, equipment, materials, and supplies for a number of operating companies, the holding company can buy in very large lots and obtain, in addition to lower prices, such advantages as better service, quicker delivery, and a prompter and more satisfactory adjustment of claims than the individual operating companies. Again, the holding company, with a number of operating companies under its wing, can afford to have a department or a subsidiary company to provide the operating companies with expert construction and engineering service at a price lower than the operating companies would have to pay outside concerns. The holding company can also give its small operating companies the benefit of high-class managerial ability and the experience which would otherwise be available only to the largest companies. Finally, it is often possible for holding company

graphical distribution, it is well-known that the Electric Bond and Share Company had operating companies in 36 states, and that each of eight other utility systems had operating units in from 11 to 29 states. While such complicated and widespread systems may not be justified from the point of view of the operating companies or the public, it is clear why the holding companies themselves desire to build up these complicated systems.

Power and Profits.—The reason is this: As holding company is piled upon holding company, power and profits become increasingly concentrated in the hands of the few men who control the topmost holding company. The point may be illustrated by the following hypothetical example given by the Federal Trade Commission:

Suppose there are 100 local power companies, the aggregate total investment in which is \$1,000,000,000, each owned and operated by a separate corporation. The total investment might have been raised by the sale in the aggregate of \$200,000,000 of common stock, \$200,000,000 of 7 per cent cumulative preferred stock, and \$600,000,000 of 6 per cent bonds. If these companies are permitted by public authorities to earn 8 per cent on the total investment, or \$80,000,000 annually, of this, \$36,000,000 would be required to pay the bond interest and \$14,000,000 as dividends on the preferred stock. This leaves \$30,000,000 for the common stockholders, either to draw as dividends or to use in further expansion of the business. This amounts to 15 per cent on the common stock investment and has been made possible out of the 8 per cent earned on the total investment only because the major portion of the total invested funds was furnished by two classes of investors whose per cent of return is limited.

Suppose, however, a particular group of promoters would like to make more than 15 per cent from these power company investments, and for this purpose forms a holding company with a total capital of \$200,000,000 (the amount of the common voting stock of the operating companies), consisting of \$100,000,000 of 6 per cent collateral trust bonds or 6 per cent debentures, \$50,000,000 of 7 per cent cumulative preferred stock, and \$50,000,000 of common stock. This group may be able to furnish the common stock money and persuade others to furnish the bond and preferred stock money, or, furnishing the common stock money, they may persuade the holders of the common stock of the local operating companies to exchange those stocks for this cash, together with the collateral trust bonds and preferred stocks. Now the \$30,000,000 earned by the local operating companies on their common stock equities would accrue to the holding company. Out of it \$6,000,000 would go as interest on the bonds and \$3,500,000 would go as preferred dividends. This would leave \$20,500,000 for the group of promoters who hold the common stock of the holding company, which amounts to 41 per cent on their investment of \$50,000,000.

This group, however, might not be satisfied with this arrangement, or it might not have as much as \$50,000,000 to invest. Suppose, therefore, that, instead of providing one holding company, it provides ten, dividing the local operating companies among them, the aggregate capital of the ten companies being the same as in the preceding case and of the same proportional structure in common stocks, preferred stocks, and bonds. Now suppose that the promoters organize a superholding company with a total capital of

\$50,000,000 (the amount of the common stock of the ten subsidiary holding companies) consisting of \$25,000,000 of 6 per cent bonds, \$12,500,000 of 7 per cent cumulative preferred stock, and \$12,500,000 of common stock. The promoters furnish the common stock money, thereby retaining for themselves the entire voting power in the whole pyramid of companies and constituting themselves the ultimate beneficiaries of the group's earning power, and sell the other securities to the investing public. The \$20,500,000 of income left after paying interest and dividends on the bonds and preferred stocks of the operating companies and of the subsidiary holding companies accrues to this super-holding company. Out of it, \$1,500,000 is required for interest on the super-holding company's bonds and \$875,000 for dividends on its preferred stock. This leaves \$18,125,000 for the common stockholders, or 145 per cent per year on the investment of \$12,500,000 made by these promoters.⁴

This illustration shows that a small group of promoters, by investing \$12,500,000, could gain control of \$1,000,000,000 worth of operating companies, and receive their money back $1\frac{1}{2}$ times each year—and the topmost holding company in this example is only of the second degree! By controlling more operating companies and carrying the holding company structure to greater heights, even better results could be obtained. Moreover, this illustration assumes that each successive holding company has acquired *all* the common stocks of lower companies, which would not be necessary for purposes of control. It also counts as profits of the topmost company only the income received indirectly from the operating companies' earnings. But holding companies also make profits from fees charged for various kinds of services performed for the operating companies. All in all, it is evident that the operations of holding companies may be very profitable to the "insiders."

The Duping of Investors.—The above description suggests that, when the business is profitable, the small group of common stockholders of the topmost holding company is in a position to get most of the cream. And, when the business is unprofitable, most of the loss is borne by the holders of the other securities, since they have furnished most of the invested funds. In this connection, it should be noted that holding companies have sometimes been guilty of unloading very poor securities on investors. A first-degree holding company holds as its principal assets the common stock of the operating companies which it controls. It has, then, a claim, partial or complete, on the residual earnings of these companies. On the basis of this stock, however, the holding company often sells one or more issues of bonds and possibly three or four issues of preferred stock, while retaining control in the hands of a small number of persons through ownership of the common stock, or such part of it as has voting power; The holding company may pay exorbitant prices for the stock of operating

⁴ Senate Document Number 213, 68th Congress, 2nd Session, pp. 173, 174, cited in C. D. Thompson, *Confessions of the Power Trust*, pp. 181-183.

companies and then proceed to sell an amount of its own securities which is far in excess of the real value of the securities which it owns.

While there may be justification for the issuance of bonds by a first-degree holding company, the fact remains that, as bonds are issued by holding companies further and further removed from the operating companies, these "bonds" become distinctly less secure than the common stock of many industries. The same is true, and to an even greater extent, of the preferred stock of high-degree holding companies. Take, for example, the case of a holding company of the fifth degree. Its assets consist largely of the stock of other holding companies. This stock represents a partial, residual claim, four times removed, on the residual earnings of the operating companies in the system. However attenuated this claim might seem to us to be, the fifth-degree holding company would often, upon the strength of this claim, issue securities which they called bonds, but which lacked almost wholly the certainty as to principal and interest which used to attach to securities bearing this name.

We see, then, that holding companies have sometimes issued securities, on the basis of fictitious asset values and paper profits resulting from stock dividends and other intercompany transactions, which did not truly represent the sums invested in underlying utility properties. These securities, issued merely on the hope of excessive income from subsidiaries, were likely to bring losses to investors. As one public utility company executive put it, "I know of no more reprehensible abuse than for speculators to buy up companies for high prices, put them into a holding company, and then, by trading on the credulity of the investing public relative to claimed increases in economy, to unload the holding company's securities at advanced prices and thus get completely out from under before the bubble is punctured, leaving the unfortunate final investor to face an angry consumer."⁵

Evils of Intercompany Relationships.—Sometimes a holding company system has been so large that the top holding company, in addition to selling bonds and preferred stock, has had to sell part of its common stock to the public, leaving only enough in the hands of the insiders to enable them to control the system. In instances of this kind, the large profits left after paying bondholders and preferred stockholders, when business was good, had to be shared with these outside common stockholders. In such cases, but more particularly when the income arising from the subsidiary companies, though sufficient to pay bondholders and preferred stockholders, was not sufficient to pay large returns on common stock, those in control of the topmost company have sometimes found it desirable to tap the income of subsidiary companies at its source. This might be done in any of a number of ways.

⁵ Samuel Ferguson, President of the Hartford Electric Company, in *The Electrical World*, March 20, 1926.

tions have attempted to influence legislation in which they were interested. It was perhaps but natural that holding companies, in a country in which other large concerns or industries indulge in such practices, would try to influence legislation through lobbying, bribery, and other methods. These methods, however, were quite as likely to be used against legislation designed to correct evils of the holding company as in favor of that proposed for the benefit of holding companies and operating companies alike. When the Holding Company Bill was before Congress in 1935, many holding companies spent large sums of money to defeat this measure. The funds were sometimes obtained through "contributions" made by the operating companies, or, again, came out of income received from operating companies in the regular course of business. In effect, then, the purchasers of utility services were paying to defeat a law intended, in part at least, to protect their interests as consumers. In addition to direct lobbying, the holding companies sought to induce security holders to write or telegraph their Senators and Congressmen urging the defeat of the bill. It was testified at a public hearing that public utility officials sent many identical telegrams denouncing this bill, signing them with names taken at random from telephone directories, and without the authorization of those whose names were used.

It has also been charged, and at least partly proved, that holding companies have conducted long and expensive campaigns of propaganda to influence public opinion in their favor. At times newspapers have been bought outright to insure favorable publicity for the industry. More often such publicity has been obtained through cordial relations established by heavy advertising in these newspapers. There is some evidence that college professors have been kept on public utility payrolls so that they might preach the gospel of the utilities; and the industry has also been successful in changing the content of some textbooks and inducing school authorities not to use others which contained unfavorable references to the industry. Utility companies have also been most generous in providing favorable materials about the industry for use in the schools.

The Question of Rates.—Prominent utility officials have often contended that, whatever might be the evils of holding companies, the rates charged by operating companies to the consumers have not been adversely affected by holding company control. Since the operating companies are only allowed to charge rates which will produce a fair return upon a fair valuation of their properties, it is said to matter little to the consumers how thoroughly watered the securities of holding companies may be, or what happens to the income of operating companies once it is received. Indeed, these officials have contended that the progressive reductions which have taken place in public utility rates indicate the benefits to consumers of utility operation under the holding company system. There may be question as to how general these reductions have been, but there is no doubt

that they have occurred in some cases. However, those which have occurred in the past few years must be discounted to a considerable extent as having possibly been produced by the threat of regulation, rather than by lowered costs.

In any case, the lowering of absolute rates means comparatively little. That is, the low rates charged today may be further above the cost of production than were the higher rates charged in previous periods. The dealings of holding companies with their operating companies have been secret, and we have had no way of knowing whether the price paid for (say) electricity in a given community was, on the basis of costs or by comparison with the rates charged elsewhere by other operating companies under the same holding company control, a fair price.

We have now reviewed briefly the principal merits attributed to public utility holding companies, as well as the principal evils with which they are charged, and are in a position to examine and appraise the public utility legislation of 1935. At this point it is only fair to say that the evils pointed out have by no means been characteristic of all public utility holding companies. Some, indeed, have enviable records for fair dealing with both their subsidiaries and the public, but others have been guilty of most, if not all, of the malodorous practices that we have described.

THE WHEELER-RAYBURN PUBLIC UTILITIES ACT

The holding company situation in the public utility field was so serious, and the powers of the state governments to control these companies were so feeble, that in 1935 the federal government undertook to provide regulation through the Wheeler-Rayburn Public Utilities Act. This Act was in two parts: Title One or the Public Utility Holding Company Act, and Title Two or the Federal Power Act. In Title One, a holding company was defined as any company which has, directly or indirectly, 10 per cent or more of the voting control of a public utility company or another holding company. Holding companies were brought under the jurisdiction of the Securities and Exchange Commission, the provision being that every holding company which, on October 1, 1935, had outstanding securities offered since 1925 and owned to some extent in other states, must register with the Commission in order to remain in business. The Commission was empowered to exempt certain companies from registration under conditions too detailed to be described here. To secure registration, holding companies must produce full and complete information about their capital, resources, officers, and business. Periodic and special reports must be filed with the Commission.

Financial Matters.—Several provisions of the Act are designed to correct specific evils that have marked the development and operation of holding companies. A uniform accounting system is prescribed for registered holding companies, and it is unlawful for any registered holding

company or subsidiary company to acquire securities or capital assets of other companies without the approval of the S.E.C. The issuance of new securities by holding companies also comes under the jurisdiction of the Commission. Security issues must be well adapted to the financial structure of the issuing company and to its earning power; the financing must be necessary and appropriate to the economical and efficient operation of the business; fees and commissions in connection with the security issues must be reasonable; in cases of guaranty or assumption, the risk must not be improper; and the terms of sale must not be detrimental to the interests of the public, investors, or consumers. The purposes of security issues must be approved by the S.E.C. No-par stock, preference stocks, and debentures may no longer be issued.

Holding companies and subsidiaries may not declare or pay dividends in violation of such rules as the S.E.C. may prescribe to protect the financial integrity of the system, safeguard working capital, or prevent payments out of capital or unearned surplus. The acquisition or redemption, by a holding company, of its own securities, the sale of its own securities or other utility assets, and the solicitation of proxies, powers of attorney, and the like, are prohibited except under rules set up by the S.E.C. Holding companies are forbidden to sell securities from door to door, and to require subsidiaries to sell holding company securities. "Upstream loans," from operating companies to holding companies, are prohibited and other loans are regulated.

Contributions of holding companies or subsidiaries to any political party or candidate are strictly prohibited. Utility lobbyists must register with the S.E.C., and disclose the subject matter on which they work, the fees they receive, and other specified information. Officers and directors of holding companies must file statements listing the securities of the holding companies and subsidiaries owned by them, and must make monthly reports of any changes in ownership. To prevent the misuse of inside information, profits realized by officers and directors from buying and selling such securities within any six-month period shall inure to, and be recoverable by, the companies, regardless of the intent of the officers and directors.

Other Intercompany Relations.—Holding companies are no longer permitted to sell to operating companies directly, or through a subsidiary company, the various types of commodities and services which we have mentioned, at whatever prices they choose to set. On April 1, 1936, it became illegal for a registered holding company to enter into or perform any service, sales, or construction contract for an associated public utility company or mutual service company. A subsidiary of a registered holding company or a mutual service company may do these things only in accordance with the rules, regulations, and orders of the S.E.C., to insure

that the contracts are performed at cost and that the burden of cost is fairly divided among the associated companies. Again, on August 26, 1936, it became illegal for a registered holding company or subsidiary to have, as an officer or director, any officer, partner, or representative of a bank, trust company, investment banking house, banking association, or firm, or of any corporation a majority of whose voting stock was owned by any bank, trust company, investment banker, banking association, or firm, except as the S.E.C. might permit.

The Act attempts to confine the activities of holding companies to the operation of gas and electric utilities and the holding of securities of such utilities. It is intended to prevent the indiscriminate combination of domestic and foreign utilities, and to prevent the use of the holding company to deny to the public the widespread and economical use of both natural gas and electrical energy, which are sometimes withheld merely because it is to the selfish advantage of a company to encourage the use of one of its products rather than another and deprive the public of the benefits of competition between the two.

The "Death Sentence" Clause.—The most famous provision of the Holding Company Act was the one containing the so-called "death sentence" for public utility holding companies. This clause directed the S.E.C., after January 1, 1938, to require by order, that existing utility holding company systems be limited to one such company, and one subsidiary holding company, and to prevent control by the two companies over more than one integrated system of operating companies. Thus, the "death sentence" applies to holding companies above the second degree. According to the Act, an integrated system of operating companies is a system of one or more units of generating plants, and/or transmission lines and/or distributing facilities, whose utility assets, whether owned by one or more companies, are physically interconnected, or capable of physical interconnection, and which under normal conditions may be economically operated as a single interconnected and coordinated system, confined in its operation to a single area or region, in one or more states, and not so large as to impair (considering the state of the arts and the area or region affected) the advantages of localized management, efficient operation, and the effectiveness of regulation.

No exceptions are permitted as to the degree of the holding companies, but exceptions may be allowed in the number of operating systems to be controlled by the two holding companies in a system. Thus, more than one integrated operating system may be controlled whenever the Commission finds that such additional systems are incapable of economic independent operation, or operation without the loss of substantial economies not otherwise obtainable, when the additional systems are located in the same state or adjoining states, and when the continued combination

of the operating systems is not so large as to impair the advantages of localized management, efficient operation, or the effectiveness of regulation. The burden of proof in each case is on the holding company.

The Welfare of Operating Companies and Consumers.—In general, the regulatory provisions of the Act were directed at specific and well-known evils. The powers given the S.E.C. differed little from those already exercised by some public utility commissions. The Act has met with fairly general approval, though public utility officials feel that some of its provisions are too severe and delegate too sweeping powers to the S.E.C.

However, the "death sentence" clause was attacked from several angles, one of which related to the welfare of the operating companies and of the consumers. It was said that the destruction of the holding companies would ruin the industry because the operating companies were dependent upon the holding companies for expert managerial services, supplies, equipment, and capital. With the holding companies gone, the operating companies would have to depend upon their own resources and would be unable to operate with their customary efficiency. The result would be higher rates for consumers, or perhaps even the outright failure of operating companies and a growing need for government ownership. Indeed, it was sometimes charged that the aim of the Act was eventually to bring all public utilities under government ownership.

Supporters of the Act do not deny that many operating companies are dependent upon holding companies for capital, services, and commodities, and that the efficiency of these operating companies would be impaired if all holding companies were eliminated. They point out, however, that not all holding companies are to be dissolved, but only those above the second degree. It is probable that operating companies already derive a major part of their benefits from holding companies of the first or second degree. Even if this is not true now, there is no reason why first- and second-degree holding companies should not be able, after a reasonable period of time, to furnish all essential capital, commodities, and services to the operating companies. If this development takes place, holding companies above the second degree will perform no useful economic function, and their dissolution will not involve loss to the operating companies and consumers. According to William O. Douglas, former Chairman of the S.E.C.: "To the extent that the holding company can justify its dominion in terms of service to the operating companies, the statute is not a 'death sentence.' On the contrary, it holds the promise of a long life and a happy one."⁶

Even though the holding companies of high degree may not be missed, it might be uneconomical to deprive a first- or second-degree holding company of all but one of its integrated systems of operating companies.

⁶ *Electrical World*, May 14, 1938, p. 1604.

But, as we have seen, a holding company may be permitted to continue its control over more than one system of operating companies, whenever such control is in the public interest. In other cases, holding companies must be reorganized, or new holding companies organized, so that only one system of operating companies will be controlled by each. Given a reasonable period of time, it should be possible to accomplish the necessary reorganization with a minimum of loss to those involved.

The Destruction of Investments.—There are many who contend that, while the dissolution of high-degree holding companies may be good ridance from the point of view of operating efficiency and consumer rates, their loss will be mourned by people who have invested in their securities. It is argued that the government, by forcing the liquidation of these companies, will destroy the investments of their preferred and common stockholders, though the bondholders may get their money back. Let us suppose that a third-degree holding company is forced to liquidate. This means disposing of its holdings of securities of other companies, and selling its other assets. Out of the meager proceeds realized from the forced sale of its assets, the company will first have to pay the bondholders in full and there will be little or nothing left for the stockholders.

Supporters of the Act admit that the investors in certain holding company securities are deserving of sympathy. Undoubtedly, some of these "investments" have lost their value completely, or almost completely. They contend, however, that the government is in no sense responsible for these losses to security holders. Rather, the responsibility rests with the holding company executives, who sold worthless or questionable securities at high prices in the gala days of 1929 and earlier. The solicitude of these executives for the security holders is touching, but untimely.

It seems apparent that many high-degree holding company securities had lost most if not all of their value before the Act was passed or was in any danger of passing. For example, shares of American Gas and Electric sold in 1929 for as much as \$225 per share and fell to \$18½, while shares in Associated Gas and Electric, which had brought \$46, were later offered at 39 cents each. Of course, as utility executives claim, not all holding companies should be blamed for the misdeeds of the guilty, but in 1929 the control of about 40 per cent of the power industry was concentrated in the hands of three large groups—the Insull group, United Corporation, and Electric Bond and Share. The stock of these companies sold in 1929 for as much as \$79, \$75, and \$189, respectively, and during the depression went as low as 0, \$1½, and \$3½ per share, respectively.

Since the shares of many holding companies had dropped, before holding company legislation became at all imminent, to a figure which was only one to five per cent of their former values, the supporters of the law suggest that something more than the prospect of adverse legislation depressed their values. They also suggest that the holding company offi-

cials, who now weep over the fate of the utility investor at the hands of a cruel government, may be shedding crocodile tears. The man who bought the stock of a high-degree holding company at \$75 a share, and watched it fall to \$1½ under a governmental policy of "hands off," is not likely to be impressed by the charge that the government, through the operation of the Wheeler-Rayburn Act, is destroying the value of his shares.

Let us see how the Act is likely to affect the owners of securities. If we are correct in assuming that, after a period of reorganization, all holding company functions contributing to the efficiency of operating companies can be performed by first- and second-degree holding companies, those who hold the securities of the operating companies should not suffer through the operation of the Utilities Act. Similarly, the holders of the securities of first- and second-degree holding companies should not be affected adversely, since those which are sound and perform a useful economic function will not be dissolved.

We may agree that the holders of stock in high-degree holding companies are in an unfortunate position, while denying vigorously that this situation is attributable to the Utilities Act. Rather, the losses that the stockholders suffer will have resulted chiefly from the fact that they were inveigled into paying very high prices for stock which was essentially and inherently unsound. In other words, they were sold securities whose total price was far in excess of the value then existing or probable future value of the assets of the high-degree holding companies whose stock they bought. The Utilities Act must indeed be embarrassing to the gentlemen who foisted these securities on the public, but such embarrassment scarcely constitutes a valid criticism of the Act.

Constitutionality of the Wheeler-Rayburn Act.—The constitutionality of the Act has been strongly challenged in the courts. When the time came for holding companies to register with the S.E.C., many refused to do so until the constitutionality of the Act had been determined. In February, 1938, it was estimated that holding companies controlling 56 per cent of the assets of utility companies subject to federal regulation had failed to register.⁷ In March, 1938, the Supreme Court ruled that the registration provisions of the Act were constitutional. The Court held that the holding company involved in the suit in question was clearly, though to some extent indirectly, engaged in interstate commerce, and that, equally clearly, the registration provisions of the Act came within the power of Congress to regulate interstate commerce.

Following this decision, several important holding companies hastened to register, but the battle is still on with respect to other matters, for the constitutionality of the "death sentence" feature of the Act remains in doubt. This provision was to be enforced as soon as possible after January 1, 1938, but the S.E.C. delayed its enforcement because of the uncer-

⁷ *Chicago Tribune*, February 25, 1938.

tain status of the Act. In August, 1938, the S.E.C. set December 1, 1938, as the final date for the submission of reorganization proposals by all holding companies under the "death-sentence" clause. On that date, the Commission announced that public utility holding companies representing "substantially 100 per cent" of the assets of the industry had furnished the Commission with plans for simplifying their corporate structures, as required by the Act.

In 1940 and 1941, virtually all of these voluntary plans for the reorganization of public utility holding companies under the "death sentence" clause proved unsatisfactory to the Securities and Exchange Commission, and the Commission began to draw up its own plans for reorganization. These plans required more drastic changes than were proposed by the holding companies. For example, the Commission's tentative finding in the case of the United Gas Improvement Company required this \$830,000,000 company—controlling 4 subholding companies, 38 electric and gas subsidiaries, and 48 non-utility companies, operating in 11 states from New Hampshire to Tennessee—to become a \$350,000,000 company consisting of 11 electric companies and very limited interests of other kinds, with its electrical facilities concentrated in an area roughly 30 by 80 miles, and centering in Philadelphia.⁸

Another tentative finding required the Commonwealth and Southern Corporation to give up all but one of its major operating units. The company, a billion-dollar concern, operates 10 utility company systems in as many states, and controls 22 non-utility and holding company subsidiaries. The company was given the choice of retaining the Georgia Power Company, the Alabama Power Company, or the Consumers Power Company as its single integrated system, while disposing of its other utility systems and non-utility interests.⁹ These findings, and the others which have been handed down, are so severe that the holding companies involved are not likely to submit to them without a struggle. In other words, we shall probably soon have a Supreme Court test of the constitutionality of the "death sentence" provisions of the Act of 1935.

The Federal Power Commission.—Title Two of the Public Utilities Act of 1935 gave important powers to the Federal Power Commission. This body had been created in 1920 by the Federal Water Power Act. In the first fifteen years of its life, its activities were limited to licensing water power projects for electrical development, regulating the accounting of such projects to prevent overcapitalization, and making power and electric rate surveys. The Act of 1935 gave the Commission regulatory powers over all facilities used for the transmission and sale of electric energy in interstate commerce, and over the sale of electric energy at wholesale in interstate commerce. The Commission is directed to divide the coun-

⁸ *Chicago Tribune*, January 23, 1941.

⁹ *Chicago Tribune*, March 20, 1941.

try into regional power districts, and to encourage interconnection and coordination of facilities within each district and between districts. Upon application of any state commission or person engaged in the transmission of electric energy, the Commission may direct a public utility (if it finds that no undue burden is thereby placed upon the utility) to connect its electric transmission facilities with those of one or more persons engaged in the transmission or sale of electrical energy, and to sell energy to or exchange energy with such persons. However, the Commission may not require the extension of generating facilities for these purposes or compel any utility company to exchange or sell energy when to do so would interfere with its ability to provide satisfactory service to its regular customers.

In case of war, or a shortage of electric power or facilities, the Commission may, upon its own motion or by request, compel a temporary connection of facilities and such generation, exchange, or transmission of power as in its judgment will best provide for the emergency and care for the public interest. For interstate purposes, the Commission has powers of control over electric utility companies similar to the powers of the S.E.C. over holding companies. That is, it controls interstate wholesale electric rates, the acquisition and sale of properties, the issuance of securities, and accounting methods. This part of the Public Utilities Act of 1935 aims to correct a weakness in the state public utility regulatory systems. In 1938, the Flood Control Act gave the Commission considerable authority in planning electric power developments at flood control dams, and in the same year the Natural Gas Act directed the Commission to regulate the transportation and sale of natural gas in interstate commerce.

THE TENNESSEE VALLEY AUTHORITY

The Nature of the T.V.A.—The public utility industry, in addition to its worries over the Wheeler-Rayburn Act, has been much concerned about governmental competition in the production and sale of electric power. While the federal government has been building dams and facilities for the production of electric power in many parts of the country, the chief concern of the industry has been the activities of the Tennessee Valley Authority. The T.V.A. is a corporation controlled by a board of three directors appointed by the President. It was organized in 1933, for the purpose of developing the Tennessee River Valley area. In 1934, when the T.V.A. project included six dams, with electric plants and transmission lines, it was estimated that the total cost would be \$310,000,000. By 1939, the project had grown to a ten-dam system, and the estimated cost was over \$500,000,000.¹⁰

The public utility industry is interested in the T.V.A. because all dams

¹⁰ *Chicago Tribune*, March 9, 1938; and C. W. Thompson and W. R. Smith, *Public Utility Economics*, pp. 683-685.

course, to lower artificially the cost of power production at the T.V.A.

It is charged that the use of the T.V.A. plants as yardsticks is unfair to the private companies, not only because of this artificially low estimate of original costs, but also because they are unlike the private plants in the extent of industrial and residential use, load factors, taxes, interest, and depreciation charges. To have to compete with T.V.A. rates, in the face of these fundamental differences, places the private companies at a hopeless disadvantage, it is argued. The T.V.A. is also criticized because its operation has deprived federal, state, and local governments of some 4½ million dollars of taxes which used to be paid by public utility companies, and because its power is purchased largely by a few large industrial consumers instead of benefiting the general consuming public of the area. .

Constitutionality of the T.V.A.—In view of these criticisms, it is not surprising that utility companies have objected strenuously to the activities of the T.V.A. Indeed, some eighteen utility companies in the southeastern part of the country brought suit, asking an injunction against the sale of power by the T.V.A., on the ground that their business was threatened with irreparable injury, if not destruction. The case came to a decision in a Federal Court in Chattanooga, Tennessee, in February, 1938. The court decided in favor of the T.V.A., holding that the utility companies have no immunity from lawful competition, even if their business is curtailed or destroyed. The judge decided that the T.V.A. dams were constructed for several other purposes—including navigation, flood control, and national defense—as well as for the development of electricity. The water stored by these dams, when allowed to pass through turbines, creates electric power. This power is the property of the federal government, and the Constitution empowers the government to dispose of its property in any way it may choose. The utility companies immediately took an appeal to the Supreme Court, which refused to reverse the decision of the district court.

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1. Why are some businesses called "public utilities"? Explain.
 2. Why has it been thought necessary for the government to regulate public utilities?
 3. How have our courts restricted the power of public utility commissions to regulate the rates charged by utility companies?
 4. Why is the valuation of public utility properties necessary? What problems arise in connection with valuation?
 5. What is meant by the prudent investment cost method of valuation? Explain fully.
 6. Is either the total par value or market value of the stock of a utility company a sound measure of the value of its property? Why?
 7. What problems are encountered in attempting to find the original cost of a utility company's properties? Explain.

8. Do you prefer reproduction cost or original cost as a method of public utility valuation? Explain.
9. What difficulties arise in attempting to establish a fair rate of return? Explain.
10. Is any principle of rate regulation feasible other than the "fair return on a fair valuation"? Explain.
11. "Despite regulation by public utility commissions, many evils have continued to exist in the public utility industry." Explain the nature of these evils.
12. What have been the principal weaknesses of public utility commissions?
13. How have two developments of fairly recent years still further impaired the ability of state commissions to regulate the utilities?
14. What is a public utility holding company?
15. How do holding companies perform certain financial functions for their operating companies? Explain.
16. What other functions are performed by holding companies for operating companies?
17. What is meant by the pyramiding of holding companies?
18. How are power and profits concentrated in the hands of a few individuals through the use of holding companies? Explain fully.
19. In what ways have holding companies sometimes been guilty of duping investors?
20. How have evils existed in the relations between holding companies and their subsidiaries? Explain.
21. How have holding companies attempted to influence legislation and public opinion?
22. What were the purposes of the Public Utility Holding Company Act of 1935?
23. How is the Securities and Exchange Commission expected to control the financial operations of holding companies under this Act? Explain.
24. How are intercompany relations regulated by the Act?
25. What is meant by the "death sentence" clause?
26. "The Securities and Exchange Commission has thus far given evidence of an intent to enforce the 'death sentence' clause rigorously." Explain.
27. Will the welfare of operating companies and consumers be adversely affected by the operation of the Act? Explain.
28. Has the government, through this Act, destroyed the investments of the holders of the securities of high-degree holding companies? Explain.
29. Explain the provisions of the Federal Power Act of 1935.
30. What is the T.V.A., and how is it related to the public utility industry?
31. Discuss the controversy which is raging over the activities of the T.V.A.

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CHAPTER 49

MONOPOLIES

IN MANY industries, though not in all, economies may be brought about through large-scale production. But even in fields where the economies of large-scale production are great, a single firm may grow to a point beyond which no economies in actual operation of the plant would result from a further increase in size—although greater size might be desirable from the point of view of efficient marketing of the product, economical financing, or bearing the risks of the business. Under such conditions, it often happens that several business plants are brought under one central control, so that all may be managed as a single business unit, though each plant is limited to the size at which it can produce most efficiently.

But the process of centralization of control need not stop here. One firm, or a group of firms, sometimes increases in size until it controls so large a part of the capacity of a whole industry that it can regulate the output of the industry sufficiently to exercise control over the price charged for its product. In such cases, whether the control over productive capacity and price is complete or incomplete, a condition of effective monopoly exists.

Combinations and Monopolies.—At the outset of our discussion, we must distinguish carefully between monopolies and ordinary business combinations. A business combination, whether horizontal or vertical, may be formed in any industry without a monopoly resulting, so long as the combination controls only a relatively small part of the total output of the industry. On the other hand, a monopoly situation may arise through the growth of a single firm, or through a trade association of several otherwise independent firms, without any actual combination of business units taking place. It follows that what is true of a combination is not necessarily true of a monopoly. A combination may be a sound and desirable economic development, while a monopoly is neither of these things. Similarly, a business combination may increase its gains by effecting real economies in production rather than by charging exorbitant prices or practicing unfair tactics toward its competitors, but this is not the method used by monopolies.

In referring to a monopoly, therefore, we shall have in mind a person, firm, combination of firms, association of firms, or simple group of

firms, which owns or controls a sufficient part of the productive capacity of an industry or business to enable it to control the price or prices charged by the whole industry or business for its product or products. It is impossible to say exactly what percentage of the productive capacity of an industry must be controlled in order to fix prices, for the percentage would vary considerably from one industry to another; but it is certain that monopoly powers can often be exercised by an organization which controls far less than 100 per cent.

We shall limit our present discussion to industrial monopolies. Public utilities, such as water, gas, and electric companies, were treated in the preceding chapter. These public utilities have long been recognized as "natural monopolies," that is, as businesses which can attain maximum efficiency only if given monopoly control and which, if organized competitively, would eventually turn into monopolies. Hence, public utilities have been permitted to operate as monopolies under governmental control. The railroads, which were also discussed separately, are more like public utilities than like ordinary industrial companies and have been accorded special treatment by the federal government.

THE DEVELOPMENT OF THE MONOPOLY PROBLEM

For many years, the existence of monopoly conditions in an industry usually meant that the field was dominated by a single large firm or by a gigantic formal combination of firms. Though monopolies in this sense existed in the United States as early as the middle of the nineteenth century, the most active period in their organization was from 1887 to 1903. The early monopolies took several forms, some of which we shall describe briefly.

The Pool.—One of the earliest types of monopolistic organization was the pool, which consisted of a group of firms combined for certain purposes, although they remained independent in other respects. As to method of operation, pools were of several types. The most common types divided total output, markets, or profits among the member firms according to some prearranged plan. In general, pools were not a very successful type of monopolistic organization. Soon after a pool was formed, the individual members, or some of them, usually succumbed to the temptation to make a little money on the side by violating the pool agreement. This often meant the end of the pool; for the agreement among the firms was not enforceable at common law, since it was an agreement in restraint of trade.

The Trust.—Another early form of monopolistic organization was the trustee device, or trust. The stockholders of the combining corporations would assign their stock with voting power to a board of trustees, and receive in return trust certificates representing the value of their properties. By holding a majority of the voting stock of the various com-

the United Fruit Company and the Standard Fruit and Steamship Company in the importation of bananas; the Pittsburgh Plate Glass Company and the Libbey-Owens-Ford Glass Company in the production of plate glass; the General Electric Company and the Corning Glass Works in the production of glass bulbs, glass tubing, and rod for electric lamps; the General Electric Company and the Westinghouse Electric and Manufacturing Company in the production of metal bases for electric lamps; the International Business Machines Corporation and Remington-Rand, Inc., in the production of electric accounting machines; the Westinghouse Air Brake Company and the New York Air Brake Company in manufacturing railroad air brakes; the Union Carbide and Carbon Corporation and the Air Reduction Company in producing compressed oxygen and acetylene; and the Texas Gulf Sulphur Company and the Freeport Sulphur Company in sulphur production.³ All these examples relate to the national market of the United States. There are many other cases in which single firms or pairs of firms control regional or local markets for various kinds of economic goods.

Conditions of effective monopoly may also exist in industries in which no single firm or pair of firms controls all or almost all of the output. Of the 1807 products studied from among those included in the Census of Manufactures for 1937, there were 291 in which the leading single company controlled between 50 and 75 per cent of the total supply. In the case of 37 products, four firms accounted for the entire supply. In 164 cases, four firms produced over 90 per cent of the supply; and in 328 other cases, the part produced by the four leading firms was not disclosed (in order to prevent the identification of individual firms). There were 670 products in which the four leading concerns turned out 75 per cent or more of the supply, or in which information on this point was withheld. The general conclusion was that from two-fifths to one-half of the goods under consideration were produced in fields in which four concerns controlled 75 per cent or more of the supply.⁴

Holding Companies.—In industries in which the greater part of the supply of some economic good is controlled by a few large concerns, these firms are usually combinations of formerly independent companies. In many cases, the large firms are holding companies, which exist for the purpose of owning and controlling the securities of other corporations. With their own securities or with cash, they buy up at least a controlling interest in the voting stock of the corporations which are to be combined, and thus are able to control management, output, and prices. The holding company is very similar to the old trustee device, the securities of the holding company taking the place of the trust certificates and the board of directors of the holding company superseding the board of trustees. However, since many states have passed laws authorizing the

³ *Ibid.*, pp. 98–110.

⁴ *Ibid.*, pp. 113–118.

tomers a uniform base price, plus freight from the basing point to the customer's geographical location. Frequently the actual freight from seller to customer is less than that from the basing point to the customer, and the difference goes into the seller's profit. Plants located outside a given basing-point district must ordinarily charge the same prices as those inside the district, when making sales in that district, and absorb the higher freight charges as best they can. Thus, a customer in a given district would be quoted the same price by all plants in the district, and by plants outside the district as well, so that price competition is eliminated. The firms which operate basing-point systems often claim that these uniform prices are only "asking prices," and that actual prices charged and received may differ somewhat from one firm to another. Basing-point systems have been used in the steel industry, the cement industry, and some 50 other industries.

Patent Pools.—Effective monopoly has been maintained in some industries by means of patent pools. When important patents are owned by a small number of large firms, each firm may grant licenses to the others to use its patents, or all firms may pool their patents. This group of firms may then use its resources to exclude new producers from the general field of production, by refusing to grant licenses to outsiders or by charging very high royalties for the use of patents. When licenses are granted to new firms, the members of the pool may attempt to control output, markets, or prices charged by such newcomers. Patent pools do not always lead to effective monopoly, but the courts have found patent-pool monopolies among producers of ophthalmic lenses, porcelain insulators, radios, and gasoline.⁶

Other Control Methods.—In addition to the methods of maintaining effective monopoly which have already been described, market-sharing is sometimes practiced by the few large firms in a given industry. Market-sharing means simply that the firms do not compete against each other for the same customers. Each firm has a particular share of the general field, and works it exclusively. Market-sharing seems to be common among investment bankers, has been practiced by meat packers and anthracite coal producers, and is said to have been used in the tobacco industry, at least in the marketing of certain products.⁷ Again, control in some industries has been achieved through interlocking directorates, stock ownership, financial relationships of the firms with a common financial organization, and in other ways.

Trade Associations.—Formal organizations of firms in modern industry usually take the form of trade associations or industrial institutes, which are voluntary, mutual benefit associations having as their members the various business firms in a certain trade or industry. A trade association may be incorporated or unincorporated. It is usually controlled by a board

⁶ *Ibid.*, p. 159.

⁷ *Ibid.*, p. 176.

of directors elected by the members and is financed by dues. The members are independent in most respects and may ordinarily enter or leave the association at will. Trade associations have many legitimate fields of activity, such as "cooperative industrial research, market surveys, the development of new uses for products, the provision of traffic information, the organization of employment bureaus, collective bargaining with organized labor, mutual insurance, commercial arbitration, the publication of trade journals, joint advertising and publicity, and joint representation before legislative and administrative agencies."⁸

But their activities may also include "the establishment of common cost accounting procedures; the collection and dissemination of statistics; the operation of price reporting plans; the standardization of products, terms of contracts, price lists, and differentials; the provision of credit information; the interchange of patent rights; the administration of basing-point systems, the joint purchasing of supplies, and the promulgation of codes of business ethics; each of them practices which may operate to restrain competition in quality, service, price, or terms of sale."⁸ There were in 1940 some 2000 trade associations of national scope in the United States, hundreds of which have been involved in anti-trust proceedings of one kind or another.

THE CASE AGAINST MONOPOLIES

The Efficiency of Monopolistic Concerns.—While cases of complete monopoly in the hands of a single company are rare in the American economy, there are many cases in which a single firm, or small group of large firms, controls a sufficiently large part of an industry to give it effective monopoly control. The attitude of most people toward complete and partial monopolies has for many years been one of acute distrust and opposition. Though not all monopolies have been successful, many have been highly so, and in most cases the reason for success seems to have been the control over production and prices, rather than any unusual economies in operation or elimination of waste. The advantages of large-scale production are many and well known, but most of them reach a limit rather quickly, and do not go on increasing indefinitely as a firm grows in size. Monopoly control is not required in order to reap these advantages.

Other advantages, not available to a single large-scale firm, may be enjoyed by certain types of business combination. They may avoid competitive duplication of plant, and of advertising and selling effort. They can eliminate a large number of competing brands, and avoid "cross-hauling" by filling each order from the nearest plant. When a period of poor business hits an ordinary industry, it may be necessary for all plants to run at part capacity, and thus run inefficiently. A combination, how-

⁸ *Ibid.*, p. 226.

ever, can often close some plants completely and keep others running efficiently at full capacity. The several plants controlled by a combination may be made to specialize in different phases of its production, and rivalry between plants may be used as a stimulus to greater efficiency. Finally, any new processes or machines owned by any one of the firms may be used by all when all are members of a combination; otherwise, each plant would usually have its own trade secrets and special methods, and no one plant would have access to all of the best methods of production. This list of advantages, though not exhaustive, is imposing; but a few moments' reflection will convince the reader that a business combination need not be a monopoly in order to enjoy these advantages. Little statistical evidence is available as to the costs of production of monopolies, but the little that we have suggests that these costs are very seldom much lower than the costs of independent concerns or of combinations which lack monopoly powers.

Monopoly Prices.—Since monopolies may claim but few, if any, economies as distinctly their own, it is evident that their success has almost always been due to restricting output and charging monopoly prices. The result has been large profits at the expense of consumers. It is, of course, very difficult to determine the exact effect of monopoly control over prices. To do this, we should have to compare the monopoly price with the price which would have prevailed under competitive conditions. Since there is no way to determine the latter, this comparison cannot be made. We know, however, that the prices charged under monopoly have usually been sufficiently high to yield large profits. It is true, as some defenders of monopolies have said, that prices in certain controlled industries have been stable or have even declined at times, but it is also true that monopoly profits may be gained without price increases. A stable price will yield large profits if it is high enough in the first place, or if it is accompanied, over a period of time, by falling costs of production. Even a falling price over a period of time will be highly profitable if costs fall more rapidly than the price itself.

The profits made by monopolies are a fair indication of the effect of monopoly control upon prices. For example, among the early trusts, the original Standard Oil Company had earnings which ranged between 48.8 and 84.5 per cent on its investment, and averaged 61 per cent between 1896 and 1906.⁹ The Aluminum Company of America made a net income of \$335,000,000 over a fifty-year period, though its original investment was only \$2,000,000.¹⁰ Among the two-firm monopolies, the Texas Gulf Sulphur Company had an average annual profit of 28.75 per cent on its investment from 1919 to 1938, and paid dividends over a period of eighteen years which averaged 95.46 per cent annually on the original value of its stock; while the Freeport Sulphur Company, over

⁹ *Ibid.*, p. 66.

¹⁰ *Ibid.*, p. 72.

a period of twenty-five years, has paid average annual dividends of 24.75 per cent on the ledger value of its stock.¹¹ It is clear that such profits can be made only from prices which are well above the cost of production level, whatever may happen to the absolute level of the prices. From the point of view of society, then, one of the principal objections to monopoly is its effect on prices and the burden thus placed on the consumers of monopoly products.

Unfair Tactics of Monopolies.—When the smaller firms in an industry operating under monopoly conditions have refused to cooperate with the monopolistic firms, or when new competition has sprung up, the monopolistic firms have often resorted to unfair tactics to attain their ends. These monopolistic firms, with large or national markets, have often engaged in local price-cutting. That is, in areas in which they have had competition, they have cut prices to the cost level, or even below cost if necessary, in order to force their competitors to take losses. Meanwhile, they themselves have been able to “break even” or make money by continuing to charge high prices in non-competitive areas. The Standard Oil Company was a notorious follower of this policy of “cut-throat competition,” but there were many others.

Firms that controlled a tremendous volume of business were once able, by playing one railroad against another, to secure rebates on freight rates, or to induce the railroads to establish particularly favorable rates out of the cities from which these firms shipped most of their products. The Standard Oil Company once made an arrangement whereby it not only received a substantial rebate on its own shipments, but also received a similar sum from the freight payments made by its competitors. The unfairness of such a policy is apparent.

Monopolistic firms have sometimes ordered dealers selling their products to refrain from handling the products of competing companies, thus limiting the market open to competitors. The International Harvester Company, among others, used these “exclusive dealer arrangements.” A similar device was the “tying contract.” The United Shoe Machinery Company, for example, leased indispensable machines on which it held patents, but required the lessee to contract also for the use of other machines on which the patents had expired, and which were offered by other firms at lower figures. In this way, the company forced shoe manufacturers to use its machinery exclusively, and thus destroyed competition.

Sometimes, monopolistic firms have interfered with the flow of services and supplies needed by their competitors. They have persuaded or forced banks to cut off credit, and to call in the loans of competing firms, and have led newspapers and periodicals to refuse competitive advertising. Railroads have been induced to develop sudden “shortages”

¹¹ *Ibid.*, p. 110.

of freight cars of the necessary type; and sellers of raw materials have been persuaded not to fill the orders of competitors, or to fill them with inferior materials or only after long delay.

When public feeling against certain monopolies has run high, they have often made it appear that firms under their control were independent. Those who might refuse to buy from the monopoly would buy from these "bogus independents," and these companies could compete with the genuine independents without their fraudulent nature becoming known. Many monopolistic firms have brought spurious lawsuits against competitors, charging patent infringement or other injury. These suits would often tie up the business of the competitors and involve them in heavy legal costs, even though the suits were eventually dismissed. Competitors have sometimes been intimidated by the mere threat of such suits. On the other hand, monopolistic firms have infringed upon the patent rights of competitors or appropriated trade secrets gained through espionage or bribery, confident that they would make more through these illegitimate acts than any amounts which the courts might award the competitors by way of damages. Customers of competitors have been bribed to cancel orders or to default on payments, and valued employees have been bribed to leave the employ of competitors.

Finally, monopolistic concerns have sought to damage their competitors' products or reputations. For instance, the National Cash Register Company is said to have "doctored" machines made by competitors so that they would break down or fail to work satisfactorily. The same company bought up competitors' machines from their users and offered them for resale, displaying them as "junk" or as "inferior products" at 30 cents on the dollar.

Monopolies and Business Cycles.—Monopolies have also been charged with increasing the instability of our economic system. In periods of good business they maintain stable prices for their products in the face of increasing production and falling unit costs, and without increasing the wages of labor significantly. Such policies, in spite of all that can be done to support consumption through installment selling or other credit devices, lead eventually to business breakdown and depression. And in periods of depression, the monopolies are likely to hold their prices at the customary level, taking losses by selling fewer units at the stable price rather than by selling more at a lower price. This policy results in laying off labor, curtailing purchases of materials and supplies, and reducing consumer purchasing power, and eventually affects all industries and adds to the cumulative downward spiral of depression. Some economists hold that cyclical swings in business can never be eliminated, or even greatly reduced in severity, so long as many of our most important industries are controlled by monopolies with their rigid or "sticky" prices.

MONOPOLIES

Monopolies and Economic Progress.—Monopolies may also operate as a bar to economic progress. Virtually complete monopolies need not worry about developing new methods and processes or making new inventions, for their profits do not depend upon continuous progress in production. Indeed, they may even go to the other extreme and acquire control of new inventions by fair means or foul, only to put them on the shelf for a long time so that they will not overturn existing conditions in the industry. However, in certain industries which are dominated by a few large concerns, there has often been keen competition in the field of technological improvement; and the public has frequently benefited by this sort of competition.

Monopoly Control of the Whole Economy.—It is sometimes asserted that the monopoly problem goes far beyond the question of monopoly control in particular industries—that our gigantic industrial and financial concerns not only control individual industries, but have extended their control to the economy of the United States as a whole, to the government of the country, and even to its public opinion. These conclusions are based on data dealing with the concentration of economic power in this country.

It is estimated that corporations now transact from 60 to 65 per cent of the total volume of business in the United States, and own almost 80 per cent of all business wealth. Moreover, the ownership of corporate wealth is concentrated in a relatively few large corporations. In 1937, 228,721 corporations with assets of less than \$50,000 each made up 55 per cent of all corporations, but owned only 1½ per cent of total corporate assets. The 394 largest corporations owned about 45 per cent of all corporate assets, though they comprised less than one-tenth of one per cent of the total number of corporations.¹² There are some 30 "billion-dollar" corporations in the United States. The largest are the Metropolitan Life Insurance Company and the American Telephone and Telegraph Company, each of which has larger total assets than any of 38 of our states. The smallest of these 30 corporations is richer than any one of 18 of our states.¹³

This concentration of business wealth in the hands of relatively few large corporations is general throughout the leading fields of industry and finance. In 1936, the 200 largest non-financial corporations had total assets of over \$75,000,000,000, or about one-fourth of the national wealth. The three largest industrials (Standard Oil Company of New Jersey, United States Steel Corporation, and General Motors Corporation) had total assets of \$5,209,200,000; the three largest public utilities (American Telephone and Telegraph Company, Consolidated Edison Company of

¹² Temporary National Economic Committee, *Final Statement of Senator Joseph G. O'Mahoney*, p. 7.

¹³ *Ibid.*, p. 5.

New York, Inc., and Commonwealth and Southern Corporation) had total assets of \$6,548,300,000; and the three largest railroads (Pennsylvania Railroad Company, New York Central Railroad Company, and Allegheny Corporation) had total assets of \$6,958,000,000.¹⁴ In 1933, the 50 largest financial corporations had total assets of some \$35,000,000,000. The three largest banks (Chase National Bank, National City Bank, and Guaranty Trust Company) had total assets of \$6,078,600,000, while the three largest insurance companies (Metropolitan Life Insurance Company, Prudential Insurance Company, and New York Life Insurance Company) had total assets of \$9,607,900,000.¹⁵

Income, Ownership, and Savings.—The concentration of corporate income is similar to that of corporate wealth. In 1937, of 477,838 corporations which made income tax returns, 285,810 had no income. The corporations which had net incomes of less than \$5000 made up 65 per cent of all which reported incomes, but received less than 2 per cent of the total income of all these corporations. At the other extreme, 248 corporations received 40 per cent of the total net income of all corporations, though they made up only one-tenth of one per cent of the total number of corporations with incomes. It might be thought that this concentration of wealth and income is unimportant, because the ownership of these corporations is popularly supposed to be widespread. Actually, however, the ownership of corporations is highly concentrated, for it is estimated that one-half of all dividends paid in the United States are received by stockholders who comprise less than 1 per cent of all American corporate stockholders.¹⁶ Moreover, the situation is not improving. In 1937, the corporations with assets of \$1,000,000 or more made up only 5 per cent of a group of non-financial corporations studied, but they had 88 per cent of the savings of all these corporations. The corporations with assets of less than \$50,000 were 59 per cent of the total group but had no savings at all.¹⁷

Interlocking Interests of Large Corporations.—The mere fact that economic power is largely concentrated in relatively few corporations does little to support a claim of monopoly control of the whole economy unless it can be shown that these large corporations work together as a group toward this end. This seems to be the case. In 1937 there were 3544 directorships on the boards of the 200 largest non-financial and the 50 largest financial corporations, and these directorships were held by 2725 individual directors. One director held 9 such posts among the 250 corporations, and there were 83 men who held 4 or more directorships. Of

¹⁴ National Resources Committee, *The Structure of the American Economy*, Washington, Government Printing Office, 1939, pp. 274-276.

¹⁵ *Ibid.*, p. 298.

¹⁶ Temporary National Economic Committee, *Final Statement of Senator Joseph C. O'Mahoney*, p. 8.

¹⁷ *Ibid.*, p. 9.

election of legislators who will repeal or amend unfavorable laws; and working later for the repeal or amendment of these laws. The efforts of business and financial interests to influence the government are not always successful, but they are effective in many cases.

Control of the Press.—A considerable measure of control over the newspapers of the country aids our business and financial groups in their efforts to dominate the American economy. Many pressure organizations which represent business and finance have large funds available for advertising, supply newspapers with "canned" articles and editorials, and in general try to keep on cordial terms with the publishers of important papers. The newspaper publishers frequently reciprocate. In the struggles between business and labor or business and government, the business side of the controversy is presented favorably by the press. Labor is commonly held responsible for industrial disputes and for any violence which results, while the government is represented as the prosecutor if not the persecutor of business. In addition to "editorializing" the news, some newspapers have suppressed or "toned down" news unfavorable to leading advertisers. On the basis of the picture presented in the last few pages, many people conclude that the problem of monopoly today goes far beyond that of price and production control in particular industries.

ATTEMPTED SOLUTIONS OF THE MONOPOLY PROBLEM

Checks on Monopoly Powers.—Even in the absence of governmental interference, the effects of monopoly control are not always so bad as they are painted. A monopoly must exercise some care as to how high a price it charges, or it may cause customers to turn to substitutes or competition to develop in the form of new firms attracted by large profits. Monopolies may conceivably moderate their policies for fear of stirring up public opinion, or because of a sense of justice or fairness on the part of their management. Even more likely, the management of a monopoly may become stagnant or inert, and fail to take full advantage of its powers and opportunities. Finally, even if a monopoly is determined to exploit the public to the utmost, it may not be possible to determine the exact price which will bring in the greatest possible total net return.

However, the people of the United States, with their strong distrust of monopolies, have not been willing to depend upon the semi-automatic forces described above to restrain the monopolies in the use of their powers. Since the monopoly movement constitutes a problem which is national in character, we have demanded federal legislation dealing with its abuses. The basic law, the Sherman Anti-Trust Act, was passed in 1890, shortly after the start of the monopoly movement but before the most active years of monopoly development.

The Sherman Anti-Trust Act.—The Sherman Anti-Trust Act was a

Act applied to holding companies, whenever these companies operated to restrain interstate or foreign commerce. The Northern Securities Company, by giving its own securities in exchange, had acquired almost complete control of the Northern Pacific and Great Northern Railroads, and would have operated to eliminate competition between these two roads. These two decisions encouraged the government to bring further suits, and discouraged the formation of additional monopoly organizations.

The Rule of Reason.—In the cases involving the Standard Oil Company of New Jersey and the American Tobacco Company, both of which were decided in 1911, the Supreme Court developed the now famous “rule of reason” for deciding such cases. Although the Court had thrice decided that the Sherman Act applied to *all* contracts, combinations, and conspiracies in restraint of interstate or foreign commerce, it now held that the Act was meant to apply only to “unreasonable restraints” on such commerce.

The Court suggested that the Sherman Act had been worded so strictly because of the many new types of contracts and combinations which were being developed, and the desire of the framers to see to it that no monopoly escaped merely because of the form in which it was organized. The contracts, or other acts, prohibited in the law were not explicitly defined and the classes of acts prohibited were so broad that almost any activities of business men might come under the influence of the Act under certain conditions. Thus, it was held, the use of reason became indispensable in deciding whether particular business activities had or had not brought about the wrongs which the statute prohibited.

As Justice Brandeis put it in 1918, in the case of the Board of Trade of the City of Chicago, *et al.*, vs. the United States: “Every agreement concerning trade, every regulation of trade restrains. To bind, to restrain, is of their very essence. The true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition.” In spite of the development of the rule of reason, the Supreme Court decided that both the Standard Oil Company and the American Tobacco Company were operating in violation of the Sherman Act, and they were ordered to dissolve within a reasonable period of time. Later on, however, under the interpretation of the rule of reason, a government case against the United States Steel Corporation was decided in favor of that company.

The Clayton Act.—Because the Sherman Act was not wholly successful in carrying out the purposes of its framers and because there was need for further clarification of its provisions, two additional laws were passed by Congress in 1914. The first of these, the Clayton Act, with certain qualifications, prohibited local price discrimination and the use of tying

investigate the manner in which any final decree in an anti-trust case had been or was being carried out. It could make public, from time to time, such portions of its information as it deemed expedient in the public interest.

With regard to conditions of competition, the Act declared that unfair methods of competition in commerce were unlawful, and the Commission was directed to prevent persons and firms from using such unfair methods. The Act did not specify what were or were not unfair methods of competition, so that the Commission was granted a wide territory within which to exercise its judgment. If the Commission had reason to believe that a person or firm was using unfair methods, it could serve a complaint, stating its charges and providing for a hearing. After the hearing, if the charges proved to be true, the Commission could order the person or firm to stop employing its objectionable methods. If the order was not obeyed, the Commission could apply to the circuit court of appeals of the district for the enforcement of the order. Once this point was reached, the court had full jurisdiction over the case and could affirm, modify, or set aside the order of the Commission. Appeals could be taken to the Supreme Court.

The Work of the Federal Trade Commission.—In general, the Federal Trade Commission has been quite successful in carrying out its manifold duties. It is sometimes said, however, that most of the work of the Commission with respect to unfair competition has concerned ordinary business men and firms rather than monopolies. Most of the unfair practices of monopolies had already been specifically prohibited by legislation, or had been adjudged illegal in previous court decisions, so that in recent years most of the unfair methods have been employed by small firms against one another or against the large firms, rather than by monopolies against small competitors.

The more recent lists of unfair competitive practices cited by the Commission include such items as (1) sales of rebuilt articles as new, (2) harassing competitors by requests for catalogues and estimates, (3) giving and offering to give premiums of unequal value, the particular premiums received to be determined by lot or chance, (4) advertising articles for sale at "slashed prices" while in reality usual prices are charged, (5) false claims of "no extra charge for credit," and (6) advertising articles for sale "Direct from Factory to You," when in fact the seller obtained his supplies from any source available and owned no factory whatsoever. These are, of course, but a few of hundreds of such practices. The Commission is also active in preventing the use of unfair practices of the types that used to be popular with the old trusts.

While much of the work of the Commission has had to do with matters which are not essentially monopoly practices, too much emphasis on this point might make us underestimate the preventive influence it has exerted. No one knows how bad monopoly conditions might have become

prevail so long as business firms in an industry were not permitted to cooperate with respect to industrial capacity, output, and prices, without being subject to prosecution under the anti-trust laws. Moreover, it was claimed that unfair methods had not been eliminated and that, under the influence of the depression, they had become more intolerable than ever.

These complaints led to the passage, in 1933, of the National Industrial Recovery Act, which authorized trade associations or other organizations of business men to draw up "codes of fair competition" for their respective industries and submit them to the government authorities for approval. These codes, after being examined at hearings attended by representatives of labor and consumers, as well as government officials, were submitted to the President and, if approved by him, thereupon constituted the laws of business conduct for the respective industries. The codes affected all firms in an industry regardless of whether they had or had not been parties to their formation.

Not only were the codes expected to enforce fair practices in the industries, but it was understood, also, that business firms would not be prosecuted under the anti-trust laws for activities which were approved under the codes. In return for these concessions to business men, the latter were required to make the codes acceptable to the government with respect to child labor, collective bargaining for employees, and maximum hours and minimum wages for their workers.

The general success, or lack of success, of the N.R.A. need not concern us here. For the present, it is sufficient to note that the codes of fair competition were rushed through and approved very hastily so that many contained provisions which encouraged the further development of monopoly conditions, under the suspension of the anti-trust laws. Of the first 677 codes, 560 contained some provision for controlling prices, directly or indirectly; 361 set up standard cost systems; 403 forbade sales below "cost"; 352 prohibited members from selling at prices below their individual costs; and 51 attempted to prevent sales at prices below some average costs of the whole industry. Ninety-one codes provided in some way for the restriction of output, by limiting the size of inventories, by forbidding increases in productive capacity without special permission, by limiting hours of operation, or by setting up fixed quotas of production or sale. Finally, some codes provided for sharing markets by prohibiting freight allowances (to keep sellers from selling in distant markets by absorbing freight), by forbidding firms to sell outside their regular market areas at prices lower than those charged at home, or by forbidding firms from selling in other zones at prices lower than those charged by firms in the other zones.²¹ Since the code system practically compelled the producers in an industry to combine, it is not surprising

²¹ Temporary National Economic Committee, Monograph No. 21, pp. 260-265.

goods may be controlled by the manufacturer all the way down the line until they finally reach the ultimate consumer.

The effect of the Act is, virtually to eliminate price competition among the various sellers of a branded commodity. While the Act states specifically that it does not intend to legalize price-fixing as between the various manufacturers of competing brands or articles, it may develop that the power to fix resale prices of their own goods will increase, rather than diminish, the tendency of "monopolistic competitors" to cooperate with respect to price policy. Hence, the ultimate effect of the Act may be to promote the development of trust conditions in industry.

In addition to the "fair trade laws," which are the state counterparts of the Miller-Tydings Act, 27 states have "unfair practices acts." In general, these measures prohibit wholesalers and retailers from selling goods at prices lower than invoice or replacement cost, whichever is lower, plus a minimum mark-up. The amount of the mark-up is determined in various ways under the different laws, but is supposed to bear some relationship to the seller's cost of doing business.

Recent Enforcement of the Anti-trust Laws.—Except for the brief period of the N.R.A., there has been in recent years a continuous attempt to enforce anti-trust legislation. A survey of the last twenty years shows that court decisions have been handed down against the firms participating in 20 price-fixing agreements, while suits have been instituted recently in a number of other cases. Hundreds of cases involving trade associations have been fought successfully by the government during this period, and there have been several cases involving basing-point systems and patent pools. Among the important suits were those brought against the Aluminum Company of America, the Bausch and Lomb Optical Company, the International Business Machines Corporation and Remington-Rand, Inc., the American Medical Association, the three leading companies producing automobiles (in connection with installment financing), and five important producers of motion picture films.

Considerations of space make it impossible to analyze these individual cases. In some instances the government has been unsuccessful in its anti-trust prosecutions, but it has fought others to a favorable decision in the courts. The government and the accused companies have sometimes agreed upon "consent decrees." In such cases, the companies promise to "cease and desist" from the coercive or monopolistic practices of which the government complains, and the government in return withholds prosecution of the suits.

A Final Estimate of the Anti-trust Laws.—In spite of whatever accomplishments may be credited to the anti-trust laws of the United States, it must be said that, in general, the government's policy of demolishing monopolies, and thus enforcing competition in industry, has not been notably effective. The criminal penalties of the Sherman Act have

business firms by the federal government, rather than by the states, or the licensing by the Federal Trade Commission of firms to engage in interstate commerce. By these methods, they would expect monopolies to be eliminated and competition restored; for the government would refuse incorporation or licenses to monopolistic firms.

President Roosevelt, in a message to Congress in 1938, recommended further measures along the lines of breaking up monopolies and enforcing competition. He proposed to facilitate convictions under the anti-trust laws by interpreting identical bids on contracts, uniform price increases, price leadership, artificial pricing systems, and other price rigidities as *prima facie* evidence of violation of anti-trust laws. Other proposals include the following: To give the Federal Trade Commission and the Department of Justice increased powers of investigation; to provide more stringent regulations for preventing mergers and consolidations when not clearly in the public interest, and for breaking up interlocking directorates and like devices; to authorize courts to require the suspension, without pay, of corporate officials responsible for anti-trust law violations; to look into the investments of insurance companies, with particular reference to their use as an instrument of economic power; to prevent the setting up of additional bank holding companies, and to require the dissolution over a period of time of those which now exist; to change the patent laws to prevent their use in suppressing inventions and fostering monopolies; and to provide further regulation of the activities of trade associations.

The Work of the Temporary National Economic Committee.—Acting upon another recommendation of President Roosevelt, Congress set up the Temporary National Economic Committee in June, 1938, to investigate the concentration of economic power in the United States. The Committee consisted of 12 members—3 each from the Senate and House of Representatives, and one each from the Departments of Justice, Treasury, Labor, Commerce, the Securities and Exchange Commission, and the Federal Trade Commission. The Committee held hearings from December 1, 1938, to April 26, 1940, received the testimony of 655 witnesses concerning the operation of 95 industries, and published 31 volumes of hearings totaling 17,000 pages. The Committee has also published a series of 44 monographs on various phases of the general problem of the concentration of economic power.

The recommendations contained in the final statement of the Chairman of the Committee, Senator Joseph C. O'Mahoney, were in the traditional vein of enforcing competition. The proposals included: "(1) National charters for national corporations, in order that these agencies may have a definite and free place in our economy, and local businesses may be differentiated and protected from national businesses; (2) the effective and thorough enforcement of the anti-trust laws, to maintain competition and to prevent all combinations and agreements that destroy business;

(3) the encouragement of new business and small enterprise, by revision of the tax laws for the purpose of encouraging new employment and new industry; and (4) a national conference called by Congress, of the various organizations representative of business, labor, agriculture, and consumers, which have for years been working on diverse phases of this central problem, might concentrate public thought and action on the objectives on which there is general agreement instead of, as now, on the objectives concerning which there is only misunderstanding, suspicion, and disagreement.”²

The Recognition and Control of Monopolies.—In view of our unsatisfactory experience with the Sherman Anti-Trust Act, it is difficult to feel great enthusiasm for these or other proposals to bolster up the traditional policy of “trust-busting” and enforced competition. An alternative policy is the recognition and control of monopolies. The government might, for example, announce that no further attempts will be made to prevent the growth of monopolies by *fair* methods, or to limit the extent to which one firm or combination of firms may control the affairs of an industry. It would be made clear, however, that the government will continue, through the work of the Federal Trade Commission, to discourage the formation of monopolies by *unfair* methods, and the use of such methods by monopolies already established. The monopolies would thus be put strictly on their good behavior. If they operated in ways incompatible with the public welfare, they would be curbed by the Federal Trade Commission. The Commission, in other words, would be given powers similar to those exercised by the Interstate Commerce Commission in its regulation of the railroads.

This would mean that, if the public welfare required it, consolidation could take place only with the Commission’s consent, and the Commission would control the issuance of securities by monopolistic firms. It would have jurisdiction over extensions or restrictions of service or output by the monopolies. Finally, it would have the power, if necessary, to control the prices charged by monopolistic firms for their products, and the wages paid to and hours of work required of their workers, in order to prevent the exploitation of either consumers or employees.

But it must not be supposed that there are no objections to a plan of this kind. It is doubtful that it would be constitutional for the federal government to assume such extensive control over monopolistic industries, under its power to regulate interstate commerce. The control of prices by government or commission is very difficult, and might easily spread to fields which were not considered in the original plan of control. How could the Commission regulate the prices of monopolized products effectively without regulating also the prices of products which

² Temporary National Economic Committee, *Final Statement of Senator Joseph C. O’Mahoney*, pp. 10-16.

might be substituted for those of the monopolistic concerns? Could wages and hours be controlled for monopolistic firms without regard to the wages and hours of other firms and industries? Would it not be necessary to set the prices paid by monopolistic firms for raw materials also, and thus to control the prices of these materials in general? As we have noted, the Interstate Commerce Commission found it difficult to control rates, fares, and other matters for the railroads without having similar powers over motor and water carriers.

There would be many other problems to solve. How would the Commission determine the prices to be charged for monopolized products? Presumably it would want to set such prices as would permit the monopolistic firms to earn a fair rate of return upon a fair valuation of their productive properties; but we have seen the difficulties involved in such a principle in connection with railroads and public utilities. Should a fair valuation be based upon the original cost of productive properties, upon their reproduction cost, or upon the capitalization of the firm? Once valuations are made, what is a fair rate of return? Should the rate vary from industry to industry? Would not any prices which might be set bring much larger earnings to some firms than to others?

Finally, we must ask whether the result of this plan would be control over monopolies by the Commission or control over the Commission by monopolies. It has been alleged in many states that commissions set up for the control of public utilities have in fact been controlled by these utilities. The Interstate Commerce Commission has not come under the thumb of the railroads, and the Federal Trade Commission has been quite independent of business control thus far, but the monopoly problem as a whole is much larger and more difficult to handle than those with which these Commissions now have to cope. The picture (presented earlier in the chapter) of the great concentration of economic power in the hands of dominant business, industrial, and financial firms, and the cooperation of these firms for national economic control, suggests the difficulty which the Federal Trade Commission would face in dealing with the problem of monopoly.

Government Ownership and Operation.—If recognition and control of monopolies through a governmental commission should prove unsatisfactory, it might be necessary, as a last resort, to turn to government ownership and operation of monopolistic industries. Of course, there are those who contend that we should not hold this policy in reserve, but should adopt it at once. They feel that monopolies can never be controlled effectively so long as they remain in private hands, and that government ownership and operation of the industries are essential for the protection of consumers, workers, investors, and producers of the raw materials used by monopolies. They hold that the government could run the industries more efficiently than the monopolies, that the industries would be op-

erated with the public welfare instead of maximum private profits as the goal, and that the government could use new devices and methods freely in the industries instead of preventing their use as monopolies have done upon occasion. Finally, it is held that the present nefarious activities of the monopolies in controlling the government and obtaining special tariff favors and other concessions would be eliminated.

However, the opponents of government ownership are equally voluble and sincere. They believe that there is no middle ground between a capitalistic economic system and a completely socialized state, and that the government ownership and operation of some industries, while others are left in private hands, could lead to only one final result—the control of all economic activity by the state. They suggest that, while the government operation of some industries might be efficient, there is little in past experience with government operation, either here or abroad, to indicate that efficiency is likely to prevail under state control.

The aim of the government in owning and operating the monopolized industries might be loftier than that which influences their operation now, but a high aim cannot make up for unsatisfactory results. The critics hold that experience tends to show that the government would be even less progressive than the monopolies in operating the industries, and that the evils of political control by monopolies at present are nothing in comparison with the evils which would result from subjecting these industries to political control entirely. To these contentions may be added the suggestion that the government ownership and operation of monopolistic industries would be a more difficult problem than the oft-proposed nationalization of the railroads, since the monopolistic industries are many and varied in their conditions and problems.

A consideration of the major arguments for and against the government ownership and operation of monopolistic industries emphasizes the difficulty of reaching a valid decision on the subject. We need not conclude, however, that the difficulties involved are necessarily insuperable. If certain industries will apparently be monopolized in any event, it may be the part of wisdom to have the monopoly powers exercised by the government with the public welfare at heart rather than by private business men motivated by their own interests. Certainly it is absurd to argue, as has sometimes been done, that the interests of private business men and those of society are always identical. For the present, however, the obstacles to government ownership and operation are sufficiently numerous and serious to lead us to favor a thorough trial of the recognition and control of monopoly, as previously outlined, before definitely committing ourselves to the more extreme plan of government ownership

1. Distinguish between business combinations and monopolies. What is the significance of this distinction? Explain.
2. Explain the principal characteristics of the pool and the trust as types of monopoly organization.
3. How important were monopoly organizations in the United States as of 1904?
4. What are some examples of complete or almost complete monopoly control in American industry at the present time?
5. "The dominant concerns in many American industries are either holding companies or mergers." Explain.
6. Show how monopoly conditions may exist in an industry even though there is no one firm or formal combination of firms which controls all or almost all of the industry's productive capacity.
7. What is the importance of price leadership, basing-point systems, patent pools, and market-sharing in connection with modern monopolies? Explain.
8. "The operation of trade associations may or may not result in monopoly conditions." Explain.
9. When monopolies are highly successful, is the reason usually found in the fact that they are able to achieve greater efficiency in production than other business units? Explain.
10. What have been the usual effects of monopoly control on the prices of the products sold by the industries in question?
11. How have monopolies employed unfair competitive tactics in acquiring and maintaining control over certain industries? Explain.
12. On what grounds may monopolies be charged with contributing to business instability?
13. Indicate the extent to which corporate wealth, income, security ownership, and savings are concentrated in the United States today.
14. Is there any evidence that large industrial and financial concerns cooperate for purposes of economic control? Explain.
15. Why is it sometimes charged that large industrial and financial concerns attempt to control the government and the press?
16. How did the Sherman Act of 1890 attempt to deal with the monopoly problem, and with what success? Explain.
17. Explain the meaning of the "rule of reason" and its importance in connection with the enforcement of the Sherman Act.
18. What were the principal provisions of the Clayton Act of 1914? How was this Act related to the Sherman Act?
19. Describe the chief powers given to the Federal Trade Commission by legislation passed in 1914. Has the Commission been able to exercise these powers effectively? Explain.
20. What was the status of the anti-trust laws under the N.R.A.?
21. What was the effect of the N.R.A. on the monopoly problem in the United States? Why?
22. Show how laws, such as the Robinson-Patman and Miller-Tydings Acts, have had a bearing on the monopoly problem in recent years.
23. Has the government's program for dealing with the monopoly problem been successful, on the whole, up to the present time? Explain.
24. Should the federal government continue in the future its traditional policy of "trust-busting" and enforced competition? Explain.
25. Discuss some recent proposals for making the federal government's present monopoly policy more effective.

CHAPTER 50

SOCIALISM AND COMMUNISM

MANY PEOPLE feel that it is useless to attempt, as we have done, to deal with economic maladjustments, such as the problems of banking, agriculture, and transportation, as separate and distinct matters susceptible of solution without reference to other problems. To these people it appears that such problems are merely symptoms which indicate that our competitive, capitalistic economic system is already, or is rapidly becoming, unworkable. If this is true, the attempt to treat these symptoms individually is doomed to failure. Those who hold this view, whom we call collectivists, believe that our traditional economic system should be abandoned and a new type of system substituted for it. Since, as we saw in Chapter 17, a system of national economic planning could scarcely be successful in the absence of important changes in the nature of our economic and political system, we shall examine in some detail the principles, and the outstanding points of strength and weakness, of two of the principal types of collectivism.

COLLECTIVISM IN GENERAL

The Characteristics of Collectivism.—Before considering socialism and communism as specific types of collectivism, we may list the characteristics which seem to be common to all types of collectivism. They are, according to one writer: "First, a condemnation of the existing political and social order as unjust; second, an advocacy of a new order consistent with moral values; third, a belief that this ideal is realizable; fourth, a conviction that the immorality of the established order is traceable not to a fixed world order or to the unchanging nature of man but to corrupt institutions; fifth, a program of action leading to the ideal through a fundamental remolding of human nature, or of institutions, or both; and, sixth, a revolutionary will to carry out this program."¹

The Condemnation of Capitalism—Distribution.—In their indictment of our present economic system, the supporters of collectivism achieve a high degree of accord. To them, one of the most objectionable features

¹ Oscar Jaszi, in *Encyclopedia of the Social Sciences*, New York, The Macmillan Company, 1935, vol. 14, p. 188.

of the present system is the existing inequality in the distribution of wealth and income. We have commented, in earlier chapters, upon the evils which result from economic inequality. It leads to the misdirection of production by consumers, and prevents the maximization of want-satisfaction from the goods which our system produces. It leads to inequality before the law, and inequality in influencing legislation and in political activities generally. It may also be an important factor contributing to business depressions. The collectivists are quite dismayed by the misery, suffering, vice, and crime which exist in the low-income groups, and by the luxury, waste, and extravagance indulged in by those with huge incomes. They object not merely to the extent and effects of inequality, but also to the way in which the inequality in income distribution comes about. They bemoan the fact that most people under our economic system must work long and hard for a miserable pittance, while a comparatively few favored individuals, through their ownership of land and capital, enjoy handsome incomes, often without lifting a hand in work of any kind. They condemn private property in land and capital, and believe that incomes should be paid solely on the basis of personal services rendered in production.

The Ineffectiveness of Production.—Quite apart from their attacks upon present-day distribution, the collectivists have much to say about the wastefulness and ineffectiveness of capitalistic production. It is charged that there is much waste through competitive duplication of productive facilities and human labor. Collectivists delight in describing, as examples of this waste, competing gasoline service stations which often occupy three, and sometimes all four, corners of busy intersections, although they sell products which are highly similar; and the half-dozen milk wagons of different companies which patrol a given city street, each serving a few consumers with dairy products which are substantially the same. Considerable waste of human and material resources also results from competitive advertising and salesmanship, which often lead merely to the transfer of customers from one competing company to another without serving any genuinely useful social purpose. Operating under the influence of self-interest and freedom of enterprise, business men, in selecting a line of production, are much more likely to consider the possibility of profits for themselves than the welfare of society. Hence, as the collectivists point out, productive resources are wasted in turning out trivial, useless, or even harmful products, while important human wants are left unsatisfied.

The Breakdowns of Capitalism.—Not only is the capitalistic economic system said to be wasteful and inefficient when it operates, but it is subject to periodic breakdowns, commonly called depressions, with economic activity at low ebb, though human wants are far from being satisfied. Although some of the conditions leading to depressions might be cor-

rected without destroying the system, the collectivists feel that these depressions can never be completely eliminated under capitalism, for they hold that depressions are inherent in the very nature of a capitalistic system. Economic activity under capitalism is said to be chaotic and planless. The individual is left relatively free to produce what he chooses, when he chooses, and as much as he chooses, without reference to what other producers are doing or the public need for the product. With hundreds or thousands of producers operating in this fashion in an industry, there is little chance that exactly the proper amount of a good will be turned out year after year, or that the output of one industry will be properly adjusted to that of others. Periodic maladjustments and breakdowns appear to be unavoidable in such a system.

Moreover, the collectivists commonly hold that in a capitalistic system there is bound to be conflict between individual and social interests. It is to the interest of society to have every economic good produced in abundance until consumers' desires for the good are completely satisfied; but it is often to the interest of producers to restrict production, raise prices, and even to gain monopoly control for the purpose of increasing profits. Profit for society can result only from abundance, but profit for given producers comes often from scarcity and high prices; for, if a producer can make his product relatively scarce, he can often command more of other products in exchange than he could secure by maximizing his own output. Thus, in a capitalistic system, the interests of society may suffer:

This conflict between individual and social interests manifests itself especially clearly after a long period of prosperity, marked by increasing production and rising prices. As the period of prosperity continues, some enterprisers appreciate the fact that it will be impossible to keep on producing increasingly larger quantities of goods and selling them at steadily rising prices. Hence, they begin to retrench in anticipation of a period of poor business. They lay off some workers, or put them on part time, and cut down their purchases of materials and supplies. Thus they reduce the purchasing power of laborers, farmers, and others, and the business of enterprisers in general falls off. They, in turn, react by further restriction of production and discharge of workers, and finally the business depression arrives in earnest. It should be noted that it is not to society's interest to have production restricted at such times. Consumers' wants for various kinds of economic goods have not declined. Society as a whole wants and needs to have production continued, or even increased, but private enterprisers, owning land and capital and faced with the actual or prospective disappearance of their profits, follow their own self-interest and retrench. In trying to protect their own interests, enterprisers may in this way do society a very ill turn. The collectivists contend that if society owned the land and capital and if business men worked for society for wages instead of profit, the situation would be vastly improved.

work and because in a capitalistic system there is always a reserve of unused laborers waiting to take the places of those already employed. In this exploitation of the workers and appropriation of surplus value by the capitalists lies the cause of the class struggle.

The Concentration of Capital and Expropriation of the Capitalists.—According to Marx, the thirst of the capitalists for gain is so great that they seize every possible opportunity to increase the amount of the surplus value. This leads to increasing misery and suffering among the workers and to the formation of an ever larger labor reserve. Moreover, it brings about an increasing concentration of capital in the hands of a few individuals; for the large enterprisers are more efficient than the small ones, and force the latter out of business, taking over their land and capital. As this process goes on, society will become more and more the victim of commercial crises or depressions until finally will come that last crisis in which the proletariat will rise up, dethrone the capitalists, and operate the material means of production in their own interests. Eventually will come a classless order in which all workers will share the income of society and the state will dwindle away—for Marx regarded the bourgeois state as an instrument for protecting the owning class in its favored position.

Criticisms of the Marxian Theories.—Marx wrote three large volumes to elucidate and elaborate his theories, and many books of criticism of his theories have appeared since his time. However, we shall be able here merely to suggest why his theories have been very largely discredited. First of all, the idea that all of man's activities can be explained in terms of his economic activities and institutions is based upon an overemphasis of the economic aspects of life. History must certainly take economic matters into account, but there are many human actions which cannot be explained wholly on economic grounds. As for the class struggle, it is obvious that there are differences between capital and labor and that their relations might be loosely termed a struggle. However, this struggle is not the only, or necessarily the most important, feature of the capitalistic system. Marx, thinking of the proletariat as an ideal theoretical class, attributed to the workers a unity of purpose and action which they do not possess. Workers have varied interests, many of which are not economic in character. Moreover, there is little reason to suppose that workers always act in accordance with their economic interests, to the exclusion of interests of other kinds. It must also be remembered that there are economic differences between different classes of labor, and these differences *in degree* may sometimes be quite as important as the difference *in kind* that exists between capitalists and laborers.

The Marxian theory of value has also been sharply and successfully attacked. According to Marx, the only element common to things which have exchange value is the labor contained in them. This contention led

him to say that articles of wealth which have not been produced by human labor have *use value*, but not *exchange value*. However, as we know, natural resources which are in no sense the product of human labor, have exchange value just as truly as have the economic goods produced by human labor. Marx never demonstrated that the value of a commodity depends upon the amount of labor contained in it. He merely attempted to show that there could be no other element common to different commodities—and this is by no means the same thing. Marx also overlooked the element of utility in connection with exchange value. His analysis of value was incomplete in that it approached the question of value entirely from the side of supply. For it should be clear that utility is an element common to all goods which have exchange value, and an element which plays an important rôle in the actual pricing of commodities in our economic system.

The theory of surplus value, also, has fared badly since Marx's time. In explaining surplus value, Marx divided capital into two parts. He said that constant capital (which we would today call fixed capital) consists of such things as machinery and buildings, and is not a source of gain to the capitalist, since this capital merely reproduces itself in the value of the things produced. He regarded variable capital, used to pay wages, as the source of the surplus value and the gain of the capitalists. But if, as Marx thought, all gain to the capitalists comes from variable capital and not from constant capital, it is difficult to understand why capitalists should introduce machinery into their industries or make use of increasing amounts of fixed capital. For the greater the quantity of fixed capital goods used, the less would be the gains in the form of further surplus value. The rate of gain to capitalists would be highest in industries using much labor and little fixed capital, and lowest in industries using little labor and much capital; and yet Marx's prediction of revolution was based upon the growth of a great army of unemployed labor, which supposedly was to result from an increasing use of labor-saving machinery.

In describing the return received by the capitalists as a surplus value filched from the laborers, Marx overlooked the element of time and the important function of waiting performed by those who save and thus make possible the formation of capital. He also largely disregarded the important administrative and managerial functions which are often performed by capitalists. Finally, he failed to explain why the capitalists, under competition—since they were making a large gain from each worker used—did not bid against one another in the attempt to hire more of these profitable laborers, until they reached the point at which the contribution of the marginal worker to production equaled, and only just equaled, the wages which had to be paid to get his services.

It would seem that Marx was only a fairly good prophet, if we may judge by subsequent events. The population has not become divided into

two distinct classes, bourgeoisie and proletariat. Instead, a large middle class has continued to exist, and there are surveys which show that most individuals, whether relatively well-to-do or poor, consider themselves members of the middle class. Under the development of the corporation and industrial combinations, there has been a considerable concentration of capital, but the concentration of *control* over capital has been more pronounced than that concentration of *ownership* which was so prominent in the Marxian analysis.

The lot of the workers has not been one of increasing degradation, misery, and squalor, in an absolute sense, since Marx's time. It is true, of course, that for some years following the Industrial Revolution the trend in the condition of the working class seemed to be in that direction; but labor organization and governmental intervention in the form of labor legislation and social insurance—measures in which Marx had no faith—have helped to reverse this trend. However, it is possible to argue that workers have become relatively worse off, and that the disparity between rich and poor has increased since Marx's time. For some years we have had a reserve of idle labor and this reserve has been large in times of severe depression, but it has hardly reached the proportions predicted by Marx.

Business depressions have probably increased in severity, in the absolute sense, as our economic system has become more extensive and more complex, but it is not clear that they have become relatively more severe. Finally, the time when all material means of production will be owned by a few, and the militant masses of the population (the proletariat) will rise up in their might and destroy these few capitalists; does not indeed appear to be imminent.²

THE ELEMENTS OF SOCIALISM AND COMMUNISM

Having described briefly the indictment which collectivists bring against the capitalistic system and their basis for hoping that it will be replaced by a different type of economic order, we now turn to a consideration of the characteristic features of socialism and communism. The terms "socialism" and "socialistic," like the word "inflation," are very loosely used in everyday conversation. Some people regard as socialistic every extension of governmental functions, even though the new functions are calculated to uphold and strengthen the existing order and thus lessen the probability of the adoption of a different type of system. Some, indeed, are inclined to view as socialistic any governmental activity, old or new, which apparently does not serve their own particular interests, and

²For a brief but searching analysis and criticism of the doctrines of Karl Marx, the student may well read Alexander Gray, *The Development of Economic Doctrine*, New York, Longmans, Green & Company, 1931, pp. 293-329. This work has been helpful in the preparation of this brief summary of the theories of Marx.

For these and other reasons, it seems that socialism, if it is to come, should await the time when a sufficient number of citizens appreciate its merits so that it can be voted into existence. But, in any event, if the land and capital are to be acquired by society, there will remain the question of whether confiscation or purchase is the better method of procedure. In general, purchase appears to be sounder than confiscation. Of course, the compensation of present owners would perpetuate, for a time, the great inequalities in wealth and income to which socialists object so strenuously. However, since the lump sums or annuities which might be granted to the present owners would not be transferable to their heirs, this problem would be a temporary one.

The Collective Management of Land and Capital.—Opinions differ, also, as to the best way to manage the socially owned industries. Some collectivists think that the central government should assume direct responsibility for the management and operation of all of the socialized industries. Others hold that management should be vested in trade unions, syndicates, or even in modern replicas of the medieval guilds. In any case, the central government would have to supervise in general the operation of the entire economic system, for there are some functions which could hardly be performed by any agency other than the central government.

Such duties would probably be performed by a governmental commission, or commissions. It would be necessary for the central agency to collect and study a great mass of statistical information relating to natural resources and other factors of production, to the wants of consumers for different kinds of economic goods, and to the extent to which these wants are currently being satisfied. This agency would have to make decisions, based upon the expressed will of the people, as to which industries should continue to operate and which, if any, should pass out of existence. It would have to decide how much of each industry's product should be made in each period, and coordinate the production of the different industries of the country so that the national income as a whole would meet the needs of this socialized people.

The Distribution of Income.—An important problem under socialism or communism, as under capitalism, would be the distribution of the national income. Should economic goods be distributed directly among the citizens or should the members of society be given money incomes with which to buy such goods as are available? The communists believe in the collective ownership of consumers' goods, as well as capital and land, and would have these goods distributed directly among the people. Socialists, on the other hand, are more kindly disposed toward the use of money and the exercise of choice on the part of consumers.

Once the *method* of distribution has been decided, it becomes necessary to formulate a *principle* of distribution. Shall the national income

erably higher than at the present time; for every worker would have included in his wage his share of social rent and interest, in addition to the payment made for his labor.

Saving and Capital Formation.—While socialism or communism would eliminate most competition, as we now know it, and would greatly limit the institution of private property, we must not assume that either form of collectivism would turn its back upon all features of a modern capitalistic economic system. Production would doubtless continue to be roundabout, large scale, and specialized in character, and would require large and increasing amounts of capital. Since collectivists frown on the receipt of interest by private individuals, the question may be asked as to how the necessary capital would be provided.

Capital formation, it will be recalled, depends upon saving. Under our present system, certain individuals must refrain from consuming to some extent, and must, in effect, elect to buy capital goods instead of consumers' goods with a part of their money incomes, if capital formation is to take place. In other words, in any society, the cost of obtaining capital goods, which will help to create a more abundant life in the future, is found in the necessity of getting along with a smaller quantity of consumable products at present than could have been obtained if the creation of capital goods had not been undertaken. In a collectivistic society, decisions as to how much to save would not be left, as at present, to private individuals motivated by the prospects of interest. Instead, the central authority would decide how much should be saved, and would carry out its decision by directing the use of a certain part of society's land and capital into the production of capital goods rather than consumers' goods. In this way, all the people would help to bear the cost of providing capital goods by having to put up with smaller real incomes currently than they would otherwise have received; and later on, when society's productivity had been enhanced by the use of this capital, presumably all would share in the greater national income.

Money and the Price System.—Another pertinent question has to do with the extent to which a socialistic or communistic economic system would make use of money and the price system. Under communism it may be assumed that money and prices would not be used. Consumers' goods, when produced, would belong to society, as well as land and capital, and the consumers' goods would be distributed directly among the people in some arbitrary fashion, so that money and prices would not be needed. Labor would have to be directed arbitrarily into the proper occupations, unless we may assume that the better nature of men would cause them, under communism, to select the occupations in which they would be most useful to society. Similarly, society as a whole, through its representatives directing the system, would have to decide what goods should be produced, and in what quantities.

While some socialists have favored the use of labor certificates or sim-

far substitutes for money, most socialists are at present resigned to the use of money and to some dependence upon prices. For one thing, prices would probably be used under socialism to direct the labor supply into the desired occupations. Land and capital, being owned by society, could be arbitrarily distributed among different industries and occupations without any great harm being done. The labor supply, however, is made up of human beings who have home ties and other associations which would make it undesirable for the central authority to shunt them from one occupation to another and from one part of the country to another in an arbitrary fashion. Consequently, socialism would probably rely upon differential wages, as far as possible, to get labor to move from one industry to another and from one locality to another in order to keep the labor supply distributed in accordance with the changing needs of society. Thus, if more workers were needed in baking bread and fewer in producing motion pictures, the wages of bakers would be raised and those of motion picture workers lowered; until workers had shifted from one occupation to the other in desired numbers, or at least trained their children to become bakers rather than actors, directors, or cinematographers.

A socialistic system would probably also depend upon prices, to a considerable extent, to get the products of industry rationed among the people as consumers. The use of prices is probably the best way to allow consumers to choose what they will consume and to permit a variation in the composition of real income as between individuals. Since society would control both the total amount of money to be given to citizens and the prices at which products would sell, it should be quite possible to distribute the output of industry among the people while giving them considerable freedom of choice. The total amount of want satisfaction derived from the national income would probably be much greater, with the use of prices and the exercise of freedom of choice, than it would be if goods were rationed directly to the consumers in certain fixed quantities.

However, a socialistic system would rely less extensively than a capitalistic system upon prices. We have already seen that socialism would not depend upon prices to govern the total amount of saving and investment, or the distribution of land and capital goods among the several industries. Moreover, it would not allow prices to determine what to produce and in what quantities. The fundamental relationship now existing between prices and costs of production, under competitive conditions, would largely disappear under socialism. Since land and capital would be owned by society, any charges made to industries for the use of these agents would be purely arbitrary. Wages would be determined by the central authority as would also the prices of finished products. Under these conditions, there would be no necessary relationship between prices and costs of production.

Let us suppose, for example, that an article produced under socialism

did not, at a price equal to "cost of production," sell in the quantity in which it was being produced. Under capitalism this situation would be expected to lead eventually to a restriction of the productive capacity of the industry and a consequent reduction of output. Under socialism the output might be maintained or even increased if the central authority thought the commodity should be widely consumed by the people. Any "loss" on this article could be covered by selling other, less essential goods at prices higher than their alleged cost of production. Similarly, the ability to charge a price higher than cost of production for an article provides, under capitalism, an incentive to increase productive capacity and output, but this would not be true under socialism. Capacity and output would be expanded only if this course of action appeared socially desirable for other reasons. Prices and costs under socialism would be used merely as bookkeeping devices to aid in planning production to meet the needs of the people, and in checking up on the degree of efficiency with which plans were carried out. They would be purely arbitrary amounts, as determined by the central authority. The price system, thus administered by the peoples' representatives, would be the servant of society and not its master.

POSSIBLE ACCOMPLISHMENTS OF COLLECTIVISM

The Wastes of Competition.—Such are the features which would probably characterize a collectivistic economic system. We must now attempt to see what gains the collectivists feel would be realized in the way of increasing human welfare, through the adoption of collectivism. In the first place, collectivists are convinced that a system of this kind would eliminate most of the wastes of competition. Since production would be socially controlled, there would be little danger of competitive duplication of productive facilities and human efforts such as mark capitalistic economic systems. Every industry would be organized into productive units of the most efficient size, and no more units would be set up than were needed to turn out the socially desirable amount of goods. Advertising, if it existed at all, would be used to strictly educational and instructive ends. With production organized for use and not for profit, there would be little danger that productive agents would be used to make trivial goods so long as important human wants remained unsatisfied, or that industries which produced useless or harmful goods would be tolerated. Since production would be organized with the interests of society at heart, collectivists believe that human wants as a whole would stand a much better chance of being completely satisfied under collectivism than under capitalism.

Individual and Social Interests.—We have already said that in a capitalistic system, the interests of individual enterprisers often lead to the limitation of certain types of goods, while the best interests of society as

sumers for its products were completely or very nearly satisfied. In other words, the time would never come under collectivism, as it does under capitalism, when business uncertainties could cause managers to discharge workers or put them on part time, to reduce purchases of materials and supplies, and to take the other steps which today lead to the vicious downward spiral of depression. Business managers, under collectivism, would be working for society, would not receive profits in any event, and would never reduce production unless instructed to do so. Thus, it is claimed, business depressions would under collectivism be only a bitter memory.

The Employment of Labor.—It is contended that under collectivism there would always be employment for all persons able to work, while generous provision would be made for those unfortunate individuals who were unable to contribute to production. In fact, all who were able to work would be required to do so in order to receive any income. Under capitalism, the ability of workers to find employment depends upon whether those persons who control land and capital can make a profit by using the workers. Under collectivism, with land and capital owned by society, workers could always be used with profit to society so long as human wants were not completely satisfied. The cost of putting laborers to work in a given line of production is, from the social point of view, only the necessity of providing them with land and capital which could otherwise be used to produce other goods. In short, the only costs would be opportunity costs, and there would be plenty of employment for labor as a whole. And if society ever managed to produce more than enough goods to satisfy the wants of consumers, it would reduce hours of work for all citizens and allow all to enjoy more leisure time. There would still be employment for all.

Saving and Investment.—Finally, it is contended that the twin processes of saving and investment would be much better coordinated under collectivism than under capitalism. Under the latter system, people often desire more funds for investment in industry than are currently being saved, so that the banks have to create extra purchasing power for investment purposes. At other times, savings pile up in our financial institutions and cannot find profitable investment. These evils, it is claimed, result from leaving these processes in the control of private individuals who react to price considerations. The processes not only are carried on wastefully, but they have important repercussions in connection with business cycles. Under collectivism, saving and capital formation would mean merely that society would choose to direct a part of its productive resources into making capital goods rather than consumers' goods. Society would not be so silly as to deprive the people of consumers' goods at a given time unless there were a real need for further supplies of capital goods; and, on the other hand, society could always withhold from its citizens enough con-

The Control of Production.—Not all objections to collectivism can be disposed of in this summary fashion, however. There are many people who believe that it would not be possible, as a practical matter, for society to control all economic activity. They believe that no men are sufficiently intelligent and capable to look after the economic affairs of 130,000,000 people more efficiently than these millions can individually direct their own affairs. Regardless of the statistical data that might be assembled and the number and character of the subsidiary organizations and agencies set up, a central planning commission would find the economic activities of this country too great and too complex for effective central control. According to these critics, it would require superhuman wisdom to decide what goods should be produced, to coordinate the activities of different industries, to control the purchasing power of the country, to keep all able persons employed, to devise a fair principle for the distribution of income, and to balance properly the production of consumers' goods and capital goods. They hold that governments have always proved inefficient in operating industries, and that, if all economic activity were to be subjected to political control, the result would be chaos many-fold worse than the disorganization and inefficiency which collectivists complain of under the present system.

The collectivists naturally do not accept these objections as sound. They admit, of course, that the change from capitalism to collectivism would not endow men with superhuman wisdom and infallible judgment. Many mistakes would undoubtedly be made in planning and carrying out the economic activities of a collectivistic society. But they insist that the probable achievements of collectivism should be compared, not with the results which would be realized under a perfectly functioning capitalistic order, but with capitalism as it has been and now is. Since some critics of our capitalistic order contend that its efficiency in satisfying human wants is but little, if any, more than 50 per cent of what might be accomplished in the existing state of the arts of production, collectivists feel that there would be some gain at least under their system. Such mistakes as might be made in planning the nation's economic affairs would tend to be overcome as we gained experience in planning. At any rate, our people would probably be more tolerant of mistakes made in the attempt to serve the best interests of society as a whole than of those which admittedly result under capitalism when individuals seek their own private interests. Given adequate information and well-developed subsidiary planning agencies in the many lines of economic activity, the collectivists feel that national economic planning is distinctly feasible and well worth trying. However, despite these claims, we believe that the practical possibility of social control over economic activity is still a debatable question. It is one which can be fully answered only by experience, and not in advance of the event.

The Selection of Leaders.—Another important question relates to the selection of leaders—those who are to fill positions on planning commissions and manage the great industrial units. Babies do not come into the world conveniently labeled “leaders” and “non-leaders”; and the men who develop leadership under capitalism do not always show exceptional prowess or promise as youths and young men. Leaders under capitalism are forged in the crucible of experience, and reach their exalted positions, as a rule, fairly late in life. Of the many who try to become great industrialists, only a few succeed. It is thus that we develop our leaders. Under collectivism, the selective influence of competition would be lacking. How, then, could leaders be chosen?

The collectivists would probably answer that, in their system, it would not be a matter of discarding all of our present industrial leaders and developing new ones from the masses at once. If collectivism were peacefully achieved, an effort would probably be made to leave those important executives and managers, who appear to merit their present positions, in places of responsibility. It is felt by collectivists that much managerial ability goes to waste under capitalism because many persons who possess ability cannot get the training necessary to fit them for high positions, or because they lack the capital or connections to make them eligible for these posts. Under collectivism, such training would be given to large numbers of people and it should be possible to select some persons who would eventually qualify for key positions in the economic order.

Incentives Under Collectivism.—Probably the most important question raised in connection with collectivism is whether, under such a system, individuals would have an incentive to work hard and make full use of their talents and abilities. Under capitalism, everyone has the incentive of personal gain to spur him on in developing his abilities to the utmost, and obtaining the highest position for which he can qualify—for large incomes and great wealth come to those who are conspicuously successful. While collectivism, as we have seen, probably would not mean absolute equality in the distribution of income, it is certain that inequality would be largely eliminated and differences in income would be very small as compared with those of today. Moreover, the larger incomes under collectivism would at most mean merely higher standards of living. No one could pile up property rights in land and capital to insure himself later a permanent income without working, or to found a family fortune. Of course, under capitalism, not all who seek great riches actually attain them, but it is commonly held that the opportunity for economic advancement affords an incentive to all. What would be the incentives under collectivism?

The question would be important and applicable to all grades of workers under collectivism—from the head planning commissioner down to

the lowliest worker. Of course, all who had the ability to do so would be required to work for their incomes, but how would efficiency be achieved among the rank and file? The man who just met the minimum requirements of his job would receive almost as much income, and have possibly as much leisure, as the one at the next machine who worked with great zeal. No one would hold any effective power of discharge over the inefficient worker, as the employer does under capitalism, because society would be obligated to furnish employment for all who were able to work. Of course, negative incentives might be provided in the form of penalties for laxity, but it is questionable how effective or desirable they would be.

What incentive would one have under collectivism to aspire to a high position in an industrial unit, with all its worries and responsibilities, if the wage paid were only slightly higher than that paid to workers in the ranks? What incentive would there be for a man in such position to be as efficient as possible, when he could not hope for profits, could not accumulate land or capital, and could not in any event pass on accumulated wealth to his heirs? Opponents of collectivism urge that, in the absence of our customary economic incentives, economic efficiency would decline and the national income would fall until, no matter how fairly it was divided, there would be poverty, and not plenty, for all. They suggest, further, that a collectivistic society would be stagnant and unprogressive, since its members would not invent new machinery and devise improved methods of production, if they could not profit personally by their use in industry.

As usual, the collectivists have ready answers to these objections. The capitalistic system, they say, does not provide incentives for all. The great inequality of wealth and income discourages the poor and limits their efforts, while the possession of great wealth by others gives these favored persons the best possible incentive to do nothing at all. Even under capitalism, some people work hard to win the esteem and admiration of their fellow men, or because they are interested in the welfare of society as a whole. Under collectivism, in the absence of economic incentives, these other motives would flourish and develop unprecedented vigor. Moreover, some differences in incomes would be granted under collectivism and, it is held, even these differences might provide considerable incentive in the absence of large differences in income with which to compare them unfavorably. Even if it were difficult to furnish adequate incentives under collectivism for individuals who had become accustomed to such "bribes" under capitalism, it is held that after a generation or so the old system would be forgotten and the non-economic incentives of a collectivistic system would be adequate. Finally, if worst came to worst and the national income should decline or fail to grow, the collectivists suggest that people would not greatly mind being in moderate circumstances if there were none who were sufficiently well off to make them feel their poverty. In so far as incentive for inventors is concerned, the collectivists

two further points. There are some who contend a system of collectivism could not long endure, because its members would become increasingly dissatisfied with the commodities and services furnished them by the government. Even now we grumble about many of the goods we buy, but our complaints are directed against many enterprisers. We feel that we are overcharged for electricity, but forget this grievance when we encounter the high price of gasoline, and we cease condemning the oil trust to complain of the outrageous price of milk. Thus, one grievance tends to cancel another; but under collectivism all dissatisfaction and condemnation would be concentrated upon the central government—the only business enterpriser. This objection is one to which no definite answer can be made one way or another; but it seems probable that if the national income were large and well diffused, the problem would not prove to be a serious one.

The Population Question.—Finally, some critics suggest that population would tend to increase under collectivism, and that this increase might lead to the downfall of the system. The theory is that population is held in check under capitalism by the desire for economic advancement on the part of the people, since too many children may keep a family from "getting ahead." Under collectivism, with jobs at good wages guaranteed to all and support assured for one's children as well as for oneself, families might increase in size to such an extent that standards of living would be sharply reduced despite our best productive efforts. Here, again, we are in the field of speculation. In Chapter 24 we noted that the number of children in a family is influenced to a certain extent, and often to a considerable extent, by non-economic considerations. Public opinion might, under collectivism, prevent an unduly great increase in numbers. Judging from our present society, we may suggest that improvements in incomes would not seem likely to lead to families of large size. In our society today, the largest families are often found among the most wretched and miserable groups. It seems possible, indeed, that the assurance of a satisfactory income to all workers might help to hold the population in check rather than to increase it. On the whole, then, the matter of the size of the population under collectivism is very largely one of conjecture.

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1. Why do collectivists think that the capitalistic type of economic system must be abandoned?
 2. List the characteristics of collectivism in general.
 3. On what grounds do collectivists condemn the capitalistic system of distribution?
 4. What is meant by "the competitive wastes of capitalism"? Explain.
 5. Are periodic business depressions inevitable under capitalism? Why or why not?
 6. State briefly the nature of the major theories of Karl Marx.

7. Are these theories generally accepted today? Explain.
8. Distinguish briefly between socialism and communism.
9. Why do socialists and communists believe that land and capital should be owned by society?
10. How would land and capital be brought under social control?
11. What is meant by "the collective management of land and capital"?
12. How would the national income be distributed under socialism? Under communism? Explain.
13. Compare saving and capital formation under socialism or communism, with the same processes under capitalism.
14. To what extent would a socialistic economy make use of money and the price system? Why?
15. Why might a collectivist society have less need for a price system than a capitalist society?
16. Why is it claimed that collectivism would eliminate the competitive wastes of our present system?
17. Could collectivism reconcile individual and social interests? Explain.
18. Would business depressions occur under collectivism? Why?
19. Why would collectivists expect to have a full employment of labor under their system?
20. Would a system of collectivism result in the destruction of the family and of religious institutions? Why?
21. Why do many people think that society could not effectively control all economic activity? What is your opinion on this point?
22. How could a collectivistic economy select its leaders? Explain.
23. How are individuals induced to engage in economic activities under capitalism?
24. Could satisfactory incentives to efficiency be provided under collectivism? Explain.
25. Should collectivism be avoided because it would result in a loss of freedom for the individual? Explain.
26. Would the population problem bring about the downfall of a collectivistic economy? Why?

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CHAPTER 51

SOCIALISM IN SOVIET RUSSIA

FOR FIFTEEN years, Soviet Russia has afforded an interesting and important example of a nation operating as a planned economy. So long as no country actually attempted to operate on a socialistic basis, discussions of the methods and possible achievements of a planned economy were highly theoretical. But Russia—or the Union of Soviet Socialist Republics, as it is now officially called—has provided a modern example of collectivism. With a land area of over 8,000,000 square miles and a population of 170,500,000,¹ Russia has undertaken to substitute a socialistic economy for the capitalistic economy of her past. Hence, the Soviet economy is deserving of careful study.

Early Developments.—Russia did not become a planned socialistic economy overnight. Soon after the capitalistic order was overturned by the revolution of 1917, an attempt was made to establish an economic system that would use none of the customary means of economic control. Money and prices were to be discarded. Consumers' desires were to be provided for through a system of rationing, and producers' needs by deliveries against special warrants. Nationalized factories were to furnish supplies of the various kinds of economic goods, while the Supreme Economic Council estimated the kinds and quantities to be produced. Industrial conscription was to be employed, to a considerable extent, to insure that workers performed the proper tasks. Russia had never achieved great success as an industrial nation even prior to the first World War, and under this unprecedented and untried type of economic system economic activity fell off to a small fraction of even its pre-war level.

In 1921, a new economic policy was adopted which restored money, prices, and buying and selling activities, and economic planning was attempted on a modest scale. Production revived gradually under this new policy, and by 1927 it had about reached its pre-war level. At this time, the first Five-Year Plan was drawn up, providing for a comprehensive program of economic planning. This Plan was announced as "completed" early in 1932, after a little more than four years of operation. The U.S.S.R.

¹ As of January, 1939, before the absorption of Latvia, Estonia, Lithuania, Bessarabia, and Northern Bukovina into the Soviet Union.

(as the Soviet Republics are commonly called) has also completed its second Five-Year Plan, and the third of these Plans was scheduled for completion in 1942. Before describing economic activity as it is carried on in the U.S.S.R., it will be necessary to examine briefly the present government of the country.

THE GOVERNMENT OF THE U.S.S.R.

The Communist Party.—Any account of the government of the U.S.S.R. which failed to describe the nature and importance of the Communist Party would be incomplete indeed, for the government and the party are one and indivisible. The Communist Party, in other words, has outright control of political and economic life in the U.S.S.R. While the party numbers only about 2,000,000 persons,² or a little over one per cent of the population, and while non-Communists are allowed to vote and are sometimes elected to political office, most of the important economic and political positions in the country are, in fact, held by party members, and the party formulates all of the important policies which are carried out by the government. It is the only political party permitted to exist in Russia today.

About half of the party members are industrial workers, the rest being peasants and intellectuals. New party members are drawn largely from the Comsomol, or Young Communist League, an organization of about 5,000,000 members from 16 to 23 years of age. This organization, in turn, has a subsidiary known as the Young Pioneers, which includes about 6,000,000 children between the ages of 10 and 16.² The party is highly organized, the organization progressing from factory, village, and city units, through district and regional congresses, to the All-Union Communist Party Congress. Membership in the party is something of an achievement. A person is placed on probation for a period before being taken into membership, and the party has periodic "purges" which are intended to rid it of members who fail to live up to party standards. The party insists upon conformity to standards of personal conduct, as well as enthusiastic participation in party and civic activities, and enforces rigorous discipline within its ranks.

The Governmental Organization.—The government of the U.S.S.R. operates on the basis of a constitution which was ratified late in 1936. The legislative powers of the government are exercised by the Supreme Council, composed of two houses, the Council of the Union and the Council of Nationalities, each having about 600 members. The Council of the Union is elected by the citizens, on the basis of one deputy, or representative, for every 300,000 citizens. The Council of Nationalities

² E. R. Sikes, *Contemporary Economic Systems*, New York, Henry Holt & Company, Inc., 1940, p. 260.

includes twenty-five deputies from each Union Republic, eleven from each Autonomous Republic, five from each Autonomous Province, and one from each National Region. All terms of office are four years in length, and the two legislative houses have equal rights. Laws are passed by a simple majority in each house, and each house elects a Chairman and two Vice-chairmen. The legislature meets twice a year.

The Supreme Council selects the Presidium, which is really a committee of the legislative body. It is composed of a chairman, 11 vice-chairmen, and 24 other members. The Presidium has certain powers, such as the power to disband the Supreme Council in the event of permanent disagreement between the houses, to call new elections, to call the Supreme Council into session, and to exercise many of the legislative functions of the Supreme Council when that body is not in session. The highest executive or administrative organization of the U.S.S.R. is the Council of People's Commissars, which is selected by the Supreme Council and is responsible to it. The State Planning Commission, which is the chief agency for economic planning, is a Committee of the Council of People's Commissars. Justice is administered by the Supreme Court of the U.S.S.R., the Supreme Courts of the Republics and Autonomous Regions, and the People's Courts. The several Supreme Courts are selected by the Supreme Councils of the U.S.S.R. and its constituent republics and regions, but the People's Courts are elected by direct vote of the citizens in the various districts. Every Union Republic and Autonomous Republic has a governmental set-up almost identical with that of the U.S.S.R.

The government of the U.S.S.R. is federal in form, but power is concentrated largely in the central government. The central government controls all external affairs of the country, including a monopoly of foreign trade, and internally controls the planning of the national economy, approves the budgets of all governmental units, administers banks and all productive or business establishments which are of All-Union importance, administers transportation and communication, controls money and credit and the use of land, provides a single national system of accounting, controls education and public health, and establishes principles of labor legislation and of legislation governing the judicial system and procedure.

It is clear that, under the present government, the legislative, executive, and judicial powers of the government are exercised by separate organizations, though the legislature is superior to the other two departments of government in power and authority. Direct elections are almost universally substituted for the indirect elections which prevailed prior to 1936. Even members of the Supreme Council are elected directly, whereas the legislature in former times was several stages removed from the actual voters. Suffrage is universal for persons 18 years of age and over,

tirely and the latter largely. Therefore, it falls to the lot of society, working through the established agencies of government, to plan and direct the use of these basic means of production. In noting how these plans are made and carried out, we shall consider agriculture separately, for the arrangements in agriculture are quite different from those in manufacture.

Industrial Organization.—Though there are some differences as between industries in the field of manufacture, the general outlines of industrial organization are quite clear. The individual enterprises or factories, operated by governmental units or cooperative organizations, are formed into trusts or combinations, sometimes one trust to an industry but usually several. The trusts exercise a considerable measure of control over the factories, and for some purposes the trust, rather than the factory, is the industrial unit. For example, the trust controls raw material supplies for its factories and markets their output. The price paid for such output is determined for the trust as a whole, rather than for individual factories. The trust also appoints managers for the individual plants, approves wage contracts, and requires the plants to use the most efficient methods available, interchange technological experiences, standardize their products, keep accounts and stocks of goods properly, and make full use of their resources.

Over the individual plants and trusts in each industry is a higher organization called the Central Administration, which supervises the work of the subsidiary organizations and sees to it that the industry as a whole carries out its part in the general economic plan. Subject to the main economic plan, each Central Administration supervises and controls the construction of new productive facilities, the use of the profits made by the trusts, and the accounting methods used by the lower organizations, besides appointing boards of directors for the trusts, engaging in research work, training personnel, and levying fines and penalties on the lower organizations. Finally, the various industries and their Central Administrations are grouped under a number of Commissariats, or departments of government and industry, each headed by a member of the Council of People's Commissars which we mentioned previously as the highest administrative agency of the government. Thus, each Commissariat includes a number of industries and their Central Administrations, each industry is made up of several trusts, and each trust controls a number of individual plants or factories.

The Method of Planning.—The general objectives to be undertaken by the economic system are planned by the Congress of the Communist Party for several years at a time. Within the general outline of such objectives, Five-Year Plans (and subsidiary annual plans within the Five-Year Plans) must be drawn up in detail for the economy as a whole, and for each organization or unit within the system. When a new Five-

Year Plan is to be constructed, the State Planning Commission, a subsidiary of the Council of People's Commissars, draws up a first draft on the basis of a mass of statistical evidence gathered for the Commission by several other agencies. The Plan is then broken up into parts, which are handed over to various subsidiary planning agencies connected with such functional units as Commissariats, administrations, trusts, and factories, on the one hand, and such geographical units as republics, provinces, regions, and communities, on the other.

The parts of the Plan are examined at each of these various functional and geographical levels, and criticisms, suggestions, and counter-proposals are offered, ostensibly for the guidance of the State Planning Commission. The parts of the Plan, together with the proposed changes, are reassembled in the hands of the Commission, which makes the final draft of the Five-Year Plan. After the final draft is approved by the officials of the Communist Party and the Supreme Council, it is again divided up, and appropriate sections are sent back to the various functional and geographical units, so that each may know exactly what is expected of it for that period.

Since the State Planning Commission is composed of about 70 persons selected from among the noted scientists, engineers, economists, and cultural leaders of the economy, and since it has a staff estimated at around 4000 technicians, statisticians, and clerks, it is probable that the Commission itself does virtually all the planning under the Russian system. The complicated procedure used in formulating the Plans probably exists for the purpose of creating enthusiasm for planning, giving many citizens a feeling that they are participating in the management and direction of the economy, and occasionally getting various factories or trusts to undertake greater productive feats than the Commission would have required of them. The Plans themselves are very bulky documents. The first Five-Year Plan totaled some 1600 finely printed pages, while the second totaled 1300 pages.

Under the Russian planned economy, the activities of every industrial unit are obviously quite closely circumscribed. A plant is given a specified output to achieve, or to exceed if possible; it is told the amount and kinds of labor it may have and the wages to pay, the amount of working capital which it is granted or may borrow, what is to be done with this capital, the amounts of materials and supplies it may have and at what prices, and the agency to which it is to sell its output and at what price. It is clear that the Plans are both physical and financial in character. From the physical point of view, they are a matter of so many units of output, so many workers of various kinds, and so much land and capital. From the financial point of view, both selling prices and costs of production are predetermined for the several industrial units.

It is something of a problem to set prices at which goods are to be

sold to the governmental agencies which then proceed to distribute them to consumers. If the government should set any one price for all concerns making certain products; some concerns could make profits without striving greatly for efficiency, while others would be unable to cover costs no matter how hard they tried. On the other hand, to specify different prices for identical goods produced in different factories would lead to many complications. The problem has been solved by having every trust take over the output of its individual factories and sell it at one price established by a price-fixing commission. This price is supposed to be sufficient to cover the planned costs of the subsidiary factories as a whole and the costs of running the trust, and to provide also for the payment of the "turnover" tax from which the government derives a large part of its revenue. The trust then computes what part of the price must be turned over to the individual factories to cover the money costs which they must meet, and the remainder is retained by the trust itself.

The Relation of Prices and Costs.—We see, therefore, that money is used in the U.S.S.R., and prices and costs are expressed in terms of money, but the relationship between prices and costs in a capitalistic order like the United States of America is very different from their relationship in Russia. The prices that Russian productive establishments are allowed to charge are usually supposed to cover costs and yield a profit, given normal efficiency on the part of the productive units; but these prices are not necessarily the same as those charged to consumers. In some cases, the prices charged consumers are less than those received by the industries, so that the government is, in effect, subsidizing these particular industries. In other cases the reverse is true, and the government reaps a profit on its sale of certain goods to consumers. Of course, when profits are made under the Russian system, they do not go to private individuals as in this country.

Another important point is that the relationship between costs and prices does not control production in the U.S.S.R. In our system, if the price at which a good can be sold to consumers is for a long time too low to cover costs of production, the quantity produced will be restricted; and the receipt of prices which are more than enough to cover costs of production will have the opposite effect. In Russia, however, production is controlled by the government and it may be decided to increase production in a non-profitable industry or to decrease it in a profitable industry; if such measures appear to be desirable from the point of view of public welfare. Prices and costs are used merely as accounting devices in Russia. They furnish a convenient medium for expressing the content of plans for different industries, and for comparing the results achieved. Since each productive establishment has its costs and prices determined for it, it makes or does not make unplanned profits according to the ef-

iciency with which it operates. A lack of profit in a particular year may mean little or nothing with regard to efficiency, but long-continued losses by a productive establishment are at least *prima facie* evidence of faulty operation. Such losses might lead to a reorganization of an establishment or to a change in management, but the fact of a profit or loss plays little part in influencing decisions of the government as to what goods shall be made or the quantities in which they shall be made.

The Problem of Planned Production.—In our own system, consumers express the relative strength of their desires for different economic goods through their willingness to pay high or low money prices, and producers presumably are guided by these prices into producing the goods most desired by consumers. But in Russia the government, through the State Planning Commission, decides what shall be produced and in what quantities; and the important question is how well production can be adjusted to meet the desires of the people as consumers under this system. In part, this coordination depends upon the temper of the planning authorities. If they decided to devote the productive resources of the country to building up a huge war machine or to supplying the country with large amounts of capital goods immediately, consumers' wants may go largely unsatisfied for a time. However, if the authorities undertake to adapt production to consumers' desires, a very considerable degree of success may be achieved. Up to the present time, it has been relatively easy to dispose of the things which were produced, because the Russian people were so desperately in need of all kinds of goods when planned production was started. Later on, when basic wants are more nearly satisfied, the problem of adjusting production to human desires may become a more serious one. However, it should be emphasized that, if maladjusted production should come about, it would not lead to a breakdown of the system. For the government controls prices and can always get rid of goods by lowering prices sufficiently or discourage their purchase by raising prices; and eventually, of course, it may be possible to adjust production so that it will be closely related to consumers' desires.

The planning authorities can measure the success of their production policies in satisfying human desires by observing the alacrity or reluctance with which consumers take economic goods off the market. In the past, however, such information was not completely reliable, for the Russian government rationed certain commodities among the consumers at artificially low prices. Under these conditions, neither the demand for rationed commodities nor that for non-rationed commodities gave an accurate picture of consumers' desires. Since people were allowed to buy only certain quantities of the rationed commodities; it was impossible to decide how much more of their incomes they would have spent on these goods had they been permitted to do so. On the other

hand, their purchases of non-rationed goods may have been much greater, *because some commodities were rationed*, than they would have been if the people had been free to spend their incomes as they desired. Now that the rationing of many kinds of consumers' goods in the U.S.S.R. has been discontinued, the reactions of consumers to planned production at planned prices will be a safer guide to the planning authorities than in the past, if they care to make use of them.

Some hope for success in the adjustment of planned production to human desires arises from the fact that the planning authorities in Russia are able to avoid some of the pitfalls of capitalistic systems. Without any great effort, the authorities decide that luxurious yachts and limousines shall not be built so long as the people have unsatisfied wants for food and clothing. It is similarly easy to decide that worthless patent medicines and other harmful goods shall not be made while the people lack adequate housing. It is possible to standardize the products turned out, instead of permitting the production of many competing varieties, and, of course, productive resources are not wasted in creating competitive advertising designed to lure customers from one brand of a product to another or even from one product to another. Finally, having decided the volume of output to be achieved in each industry, the planning authorities can see to it that the productive facilities of the industry are only sufficient to insure this output. The output decided upon may or may not be the proper quantity from the point of view of consumers, but in any case it is possible to provide for the amount planned without the wasteful duplication of productive facilities, which is characteristic of competitive economic systems.

AGRICULTURE IN THE U.S.S.R.

Agriculture in the U.S.S.R. is planned in much the same way as manufacturing, but the government does not operate agricultural establishments to the same extent as industrial establishments. The government owns farm land as it owns other kinds of land, but it actually directs only a relatively small part of agricultural production. For the most part, reliance is still placed in individual initiative and the incentive of pecuniary rewards to induce the farmers to produce in abundance.

The State Farms.—Soviet Russian agriculture is organized in three main forms. First, there are state farms. These are operated directly by the government through agricultural trusts, and their organization is sufficiently similar to that of the manufacturing industries to make a detailed description unnecessary. The total output of these farms must be turned over to the appropriate governmental agency at specified prices, and the farm workers are paid wages. When the state farms were first set up, the emphasis was on great size. The minimum size was about

5000 acres, and some farms, in grain production, "embraced hundreds of thousands of acres, with huge fleets of combines, batteries of searchlights for night work, radios sending orders to the harvesters encamped for weeks in the distant fields, and airplanes bringing their medicines, magazines, and entertainers."³

Since the state farms, under the first Five-Year Plan (1928-32), increased rapidly in number and in the proportion of the total cultivated area which they controlled, it was widely assumed that a gradual shift of agricultural activity from other types of farms to state farms was desired by the government. However, the large state farms were inefficient, as was indicated by poor crops, a heavy mortality rate for livestock, frequent changes in officials, and high labor turnover. As a result, some state farms have been broken up into smaller collective units, and the percentage of the total cultivated area controlled by the state farms declined from 12.1 in 1936 to 8.9 in 1938.⁴ This may mean that Russia intends to depend permanently on collective or cooperative farms for most of her agricultural production.

The Collective Farms.—Collective farms are the most important type of farm organization in the U.S.S.R. They vary in size from a dozen to more than a thousand peasant households each. The average collective farm contains about 130 peasant families and 1300 acres of land.⁵ Under the usual form of organization, the peasant retains his dwelling, livestock for purely domestic use, household goods, and a little land for a garden; but the rest of the land, buildings, machines, tools, and livestock are used collectively. These collective units do not, as a rule, own many large agricultural implements, such as tractors or combines, but receive the services of such equipment from machine-tractor stations, of which there were some 6350 scattered over the country in 1938.⁶

The peasants work in common, performing planned and assigned tasks under group leaders. Their incomes depend upon a number of factors. In many cases, a portion of the crop must be set aside for use as food or fodder. Deductions are made to pay taxes to the government, interest or principal on loans which the farm may have recovered from the government, and rent for the use of farm machinery borrowed from machine-tractor stations. The rest of the crop is sold to the appropriate governmental agency, and the money received is distributed among the collective farmers. The work of the farmers is divided into seven categories, with the lowest getting one-half labor day's credit, and the highest two labor days' credit, for each day's work. Each farmer gets a share of

³ A. R. Williams, *The Soviets*, New York, Harcourt, Brace and Company, Inc., 1937, p. 173.

⁴ M. T. Florinsky, *Toward an Understanding of the U.S.S.R.*, New York, The Macmillan Company, 1939, p. 199.

⁵ A. R. Williams, *The Soviets*, p. 173.

⁶ M. T. Florinsky, *Toward an Understanding of the U.S.S.R.*, p. 205.

the farm income on the basis of the number of days worked and the category into which his type of labor falls.

Since the government does not operate the collective farms, it is necessary to employ devices to insure that the collective farmers will raise the desired types of products in appropriate quantities, since otherwise the plan for the whole economy might be seriously disrupted. Such devices lie ready to hand in the Russian system. Collective farmers are induced to raise the planned crops by being granted low taxes, low interest rates or outright grants of funds, low charges for machine-tractor service, and high prices for the portion of crops that is available for sale. Collective farmers who raise the "wrong" crops may be penalized by high taxes; high interest rates, repayable loans, or even denials of credit; high charges for machine-tractor service, or even an artificial "shortage" of such service; and low prices for the remainders of their crops. Thus, the operations of the collective farmers are controlled by working on the economic motivation of the farmers.

The number and importance of the collective farms have been increasing by leaps and bounds. Under the first Five-Year Plan, their number increased from 33,300 to 211,100, and their cultivated area from 2,517,000 hectares to 94,038,000 hectares, or from 2.2 per cent of the total cultivated area of the country to 70 per cent. By 1937, there were 243,700 collective farms, cultivating 121,001,000 hectares, or 89.4 per cent of the total cultivated area.⁷ The development of the collective farms was continued under the third Five-Year Plan (1938-42).

Peasant Farms.—Finally, some farms are still operated by peasants individually. They do not, of course, own the land, but they support themselves by working it and selling their surplus products. Like the collective farmers, they must sell a certain percentage of their output to the government at low fixed prices (as a tax), and in general they are treated somewhat more harshly in this respect than the collective farmers, in order to discourage the individual type of farming. In 1928, individual peasants operated almost all of the cultivated area of Russia, while in 1937 their holdings had declined to well under one per cent of the total. Soon they may disappear altogether.

THE DISTRIBUTION OF INCOME

Land and Capital.—Since land in the U.S.S.R. is owned by society as a whole, private individuals do not receive rent. Land is apportioned among industries in accordance with the plans for economic activity. The industries are not charged rent for the use of the land, though certain

⁷ Birmingham University, Bureau of Research on Russian Economic Conditions, *Results of the Second Five-Year Plan and the Project of the Third Five-Year Plan*, p. 8.

taxes (such as those imposed upon farmers by requiring them to sell a part of their crops to the government at specified low prices) might be construed as rents. Again, the funds which are available for capital investment are apportioned among the industries by several government banks. Here, too, there is no consideration of the possible earnings of capital in different uses, or of the rates of interest which industries might be willing to pay. The assignment of capital funds (and the interest, if any, that is charged) depends wholly upon plans which have been made in the light of the need for expanding productive facilities in the several industries.

With respect to the volume of new capital, as distinguished from the rationing of existing capital, the situation is a little more complex. In a physical sense, the process of saving and capital formation is carried on collectively. That is, the Planning Commission decides that, in the next five years, say 50 per cent of the national income should take the form of new capital goods instead of new consumers' goods and services. It plans accordingly, and sees to it that the plans are carried out. The cost of saving and capital formation is the same in Russia as elsewhere. That is, the cost of augmenting the supply of producers' goods, or capital, which will make for a more abundant life in the future, is the necessity of accepting for the present a smaller real income in the form of consumers' goods; for, in directing resources into the construction of capital goods, the productive factors available for turning out consumers' goods are diminished for the time being. In capitalistic countries, the relative amounts of capital formation and present consumption are determined by individuals, influenced by interest rates and the prices of consumers' goods, while in Russia the decision is made by the Planning Commission without any necessary regard for the desires of consumers. If the government goes in so extensively for capital construction that immediate income in the form of consumers' goods is unduly diminished, the people have to adjust themselves to the situation.

In regulating saving and capital formation, the Planning Commission might adopt either of two plans. The first is to see to it that, in a given year, the people receive money incomes just large enough to take the available consumers' goods and services off the market. The second plan is to give the people of the country a total money income equal to the value of the entire national real income, and then recapture sufficient of the money income so that what remains just buys the available consumers' goods and services. Strangely enough, the second method is used in Russia.

The measures used to recapture a part of the money incomes are various. Attempts are made to induce the citizens to save, and to invest their savings in government bonds or savings accounts. The products of some industries are sold at prices somewhat higher than planned costs,

so that planned profits are made. A turnover tax, similar to a sales tax, is collected on many products. The rate of this tax is as high as 90 per cent on individual products, and in some periods has amounted altogether to some 60 per cent of the total receipts from retail trade.⁸ Other taxes are levied as well, and individuals are required to contribute to funds for social security and other purposes. In the end, the consumers are presumably left with enough money income to buy the available consumers' goods and services, but no more.

The Apportionment of Labor.—Since rent and profits do not accrue to individuals in Russia, and since the amount of interest received by private individuals is negligible, it follows that the national real income available for consumption is distributed in the form of wages. The apportionment of labor among industries and occupations, and the determination of the wages to be paid for different types of labor, have given some trouble to those in authority. Since land and capital are not human agents of production, and have no feelings or home ties, they may safely be assigned in arbitrary fashion to various industries and parts of the country in accordance with the plan. But the case of labor is different. It would be inhumane, and probably uneconomical as well, to assign labor in a purely arbitrary fashion. On the other hand, the workers cannot be depended upon to move spontaneously to the positions in which they are most needed and can be of greatest service to society.

In this dilemma, the government has had recourse, for the most part, to the capitalistic method of rationing the labor supply. High wages or superior rations at government stores have been used to attract workers to industries and posts where more labor is needed, and low wages or inferior rations to get them away from occupations where less labor is required. Because of preferences, habits, and prejudices on the part of the workers, these inducements do not work perfectly in apportioning the labor supply in Russia; but neither do they work perfectly in capitalistic countries. In general, the freedom of movement of Russian workers is so extensive that it has resulted in high labor turnover and much absenteeism.

Differential Wages.—Even the best economic plan is of little use unless it is efficiently carried out. To encourage efficiency, it has been found necessary in Russia to reward good work with relatively high wages. Wage differentials have been used, also, in the hope of getting people to accept difficult and responsible positions requiring considerable ability and training. But the distribution of national income according to the productivity of labor is quite a different thing from equal distribution, or distribution on the basis of needs. Moreover, wage differentials based upon productiveness are especially embarrassing to the Communists of Russia, who have held that common labor is as honorable an occupa-

⁸ M. T. Florinsky, *Toward an Understanding of the U.S.S.R.*, p. 164.

tion as any, and is entitled to as high a wage. However, embarrassing or not, it has been necessary to make this concession to capitalistic methods.

But it may be said that wage differences in Russia are small as compared with differences in money income in capitalistic societies. The ratio between the highest and lowest money wages in Russia was said to be about 12 to 1 in 1937,⁹ whereas in this country the ratio between the highest and lowest incomes is thousands to one. Since 1938, definite maximum differentials have existed in certain occupations in Russia. That is, the lowest rate of pay for workers in industry and transportation was fixed at 110 rubles per month, and the highest rate at 2000 rubles per month.¹⁰ The wages of farm laborers and some other classes of workers may sometimes fall below and sometimes rise above the minimum for workers in industry and transportation. If, however, 110 rubles per month is considered a minimum for Russian workers on the average, the wage differential from top to bottom is clearly a little over 18 to 1.

In any case, money wages do not tell the whole story, for all Russian workers receive some services directly from the state without charge. If such free services were distributed more unequally than the money wages, they would make for increasing inequalities in real income, but the chances are that these services do not vary greatly in amount from one person to another. Thus, if both the 110- and the 2000-rubles-a-month workers received 50 rubles' worth of services free in each month, the differential in real income would fall from approximately 18 to 1 to a little less than 13 to 1.

There is another reason why differences in money wages have not meant corresponding differences in real wages in Russia in the past. Under the old system of distributing consumers' goods, a man with a money income ten times as great as that of another may have had a real income only (say) twice as great. For both men were probably allowed to purchase the same quantities of rationed goods *at low prices*, but the one with the larger money income may have had to spend the balance of it in the open market at prices many times as high as those of rationed commodities. Hence, his advantage in terms of real income may have been relatively small. Indeed, workers receiving low money wages were sometimes definitely favored in the matter of rationing.

The differences in real wages in Russia have been so small that many people question that they result in efficiency or even the voluntary acceptance of the more difficult and responsible positions. This problem of providing incentives under the relatively equal income distribution of a planned economy was discussed in the preceding chapter, and need not be enlarged upon here. At any rate, Russia does not depend entirely

⁹ *The Nation*, November 13, 1937, pp. 523-526.

¹⁰ M. T. Florinsky, *Toward an Understanding of the U.S.S.R.*, p. 168.

upon financial or economic incentives in her control of the labor supply. If worst comes to worst, the government has the power to draft or conscript labor to serve in any and all industries, and severe punishments may be imposed for inefficiency. The members of the Communist Party and the Russian Army are also available as an emergency labor force which may be arbitrarily assigned to any type of work anywhere, and the Young Communists are subject to virtually the same regulation. When workers have been placed to the satisfaction of the authorities, there have been devices available to keep them there. These devices have included keeping the workers in arrears in their pay, and issuing ration cards through the factory so that a worker has had to surrender his ration card if he has given up his job.

THE MARKETING OF CONSUMERS' GOODS

Until quite recent times, the process of getting economic goods into the hands of final consumers was very complicated in Soviet Russia. At the beginning of the first Five-Year Plan, some stores were operated directly by the government, others were run by cooperative associations, and still others by private individuals. The private traders were virtually eliminated by 1933, and the business was about equally divided between cooperative and government stores. Since that time, the government stores have become more and more important, and have taken over all of the business in the cities. In 1937 the government stores controlled approximately two-thirds of the retail trade.

Rationed and Unrationed Commodities.—In the early years of economic planning, there were several types of "closed" stores in the Russian merchandising system. In one type, only the workers in particular enterprises could buy at low prices, on the basis of ration cards. This arrangement provided a means of favoring important groups of workers. In a second type of closed store, all citizens possessing ration cards could purchase definite physical quantities of specified goods. Their prices were higher than those of the stores operated for the benefit of the workers of particular enterprises, but lower than those in the "open" stores in which anyone could buy as much of any available commodity as his purchasing power would permit. Finally, there were special stores (Torgsin and Isnab) at which foreigners traveling or employed in Russia could make purchases.

The use of ration cards did not always indicate extreme scarcity of the rationed goods. It merely meant that these goods were being sold in the closed stores at prices which were very low in view of their limited quantities. The goods could have been distributed just as effectively without rationing, by allowing their prices to rise to any level to which the competitive bids of buyers might force them. But these

high prices would have resulted in persons with relatively large money incomes getting all the goods, while less fortunate persons were excluded from the market altogether. By rationing at low prices it was insured that most persons, regardless of the size of their incomes, would be able to buy small amounts of these commodities. The rationing method constituted a severe restriction on consumers' freedom of choice, for ration cards were honored only in terms of the rationed commodities, while the possession of money income, without rationing, would permit the individual to buy whatever he chose. However, this restriction of choice was probably not a serious matter, so long as rationing was confined to the necessities of life.

The End of Rationing.—The rationing of bread and flour ended in 1934, and that of other commodities in 1935. Anyone may now buy as much goods as he wishes in any shop, within the limits of his purchasing power. The retail prices of goods are not uniform throughout the country, but they are the same in all stores within each of eight zones or districts. Rationing came to an end as the result of increased production of consumers' goods, the diminution of the need to favor special groups or classes of persons, the increasing effectiveness of wage differentials in distributing the labor supply among industries and places, and the desire to improve the methods of retailing, which did not need to be very well managed so long as people purchased on the basis of rations.

The changes which have been made are for the better, though the merchandising system is still under close governmental control. The government ownership and operation of the basic means of production, combined with considerable freedom of choice on the part of the citizens as to what they will consume, come close to the ideal of a socialistic society. The reactions of consumers in the market now give the planning authorities a more nearly accurate idea than in the past of their success in adapting planned production to the wants of consumers; and these authorities, in deciding upon the goods to be made, may be more responsive than formerly to the wishes of consumers. This does not mean, however, that the consumers will actually dictate what shall be produced. The government will still be free to produce a given commodity in large quantities, if it is felt that the article should be widely consumed, even though it must be sold at a price well below costs of production. In similar fashion, the willingness of consumers to take other articles at high and profitable prices may be ignored by the authorities, and the output of these articles be limited closely.

INTERNATIONAL TRADE AND MONEY

The Trade Monopoly.—While Russia has many and varied productive resources and is, at least potentially, more nearly self-sufficient than most economies, she has had at times to depend upon foreign countries for

supplies of several kinds. Moreover, she has tried to make sure that importing and exporting will be carried on only when the country's interests require them, for the international trade of the country is carried on as a governmental monopoly. The government has also monopolized international financial operations, conducting them in the past in terms of an artificial monetary unit which was not used domestically. When a quantity of a foreign product is essential to the operation of the plan, the trading monopoly is in a strong position, for it can sell Russian products abroad at almost any prices in order to obtain purchasing power in other countries. It could, for example, sell wheat abroad at a price only half as high as that which the government paid the farmers, and the government would make up the loss incurred in this way by selling other articles in the domestic market at a profit.

However, the trading monopoly has to be careful about dumping goods abroad, lest other countries refuse on this account to trade with Russia; and, of course, it cannot command higher prices in the world market than the exporters of other countries are getting. Any sharp fall in the world price of a good which Russia is exporting means that a larger quantity than usual of the good must be sent from Russia to get a given amount of purchasing power abroad. This means, in turn, taking more goods than usual away from the Russian consumers. It is quite clear, then, that in Russia the costs of importation lie in the amounts of exports which must be given up in exchange and hence subtracted from domestic consumption.

Control of the Money Supply.—The issuance of money in Russia, while theoretically limited by requirements for the maintenance of gold or other reserves, is in reality entirely under the control of the government. Moreover, since the government has maintained a monopoly in international trading and in international financial operations, using an artificial monetary unit, the management of the domestic monetary supply has been freed from the influence of such things as international gold movements, interest rates at home and abroad, the international balance of payments, and fluctuations in foreign exchange rates, which are of importance to capitalistic countries under normal conditions. Nothing that happens in the international field can force Russia into inflation or deflation at home, or cause her to expand or contract her currency and credit.

It appears, then, that the monetary problem is primarily one of adjusting the supply of money to domestic needs. That is, the government must be sure that the citizens receive enough purchasing power to enable them to remove from the market the available quantities of goods at the prices at which these goods are offered. However, the overissue of currency would matter relatively little. Since the government controls prices

rigidly, the issuance of excessive amounts of currency could not raise prices, but instead would only increase the unspent surpluses in the pockets of consumers. The use of money involves the use of money prices and, as we have seen, the Russian economy is quite experienced in pricing goods in terms of money. However, it will be recalled that price movements are not so influential in Russia as elsewhere. In distributing consumers' goods among the citizens and in apportioning the supply of labor among industries and occupations, price movements operate to some extent in Russia as in other countries. But they have little, if any, influence on the distribution of land and capital among industries, on the total volume of saving and investment, and on the determination of the kinds and quantities of economic goods to be produced.

ACCOMPLISHMENTS OF RUSSIAN ECONOMIC PLANNING

General Results.—The Russian planned economy is still too young to permit us to reach any complete or final appraisal of its accomplishments and failures, but certain tentative observations may be made on the basis of the only available type of information—the official statistics published by the Russian government itself. The fact that Russia has been able to keep a planned economy operating at all might almost be listed as an accomplishment, since many people doubted the possibility of such an achievement before the Russian experiment actually began. However, official statistics indicate not only continued operation but rapid progress in many respects. For example, the Russian national income, which had amounted to some 21 billion rubles in 1913, and 25 billion in 1928, increased to over 45 billion in 1932 (after the first Five-Year Plan), and to 96 billion in 1937 (after the second Five-Year Plan), and to 125.5 billion in 1940. The third Five-Year Plan called for a further increase to approximately 173 billion rubles by 1942.¹¹

Another accomplishment is found in the extremely rapid industrialization of Russia under the planned economy. The capital investment in industry amounted to 52½ billion rubles under the first Five-Year Plan, and 115 billion under the second Five-Year Plan. It was expected to reach 180 billion rubles under the third Five-Year Plan, and had reached 108 billion by the end of 1940.¹² The number of workers in large-scale industry increased from 3,000,000 in 1913 (and 1928) to 6.4 millions in 1932, and 7.7 millions in 1936. It was expected to

¹¹ H. Johnson, *The Soviet Power*, New York, International Publishers, 1940, p. 194, and N. Vosnesensky, *Economic Results of the U.S.S.R. in 1940 and the Plan of National Economic Development for 1941*, Moscow, Foreign Language Publishing House, 1941, p. 10.

¹² M. T. Florinsky, *Toward an Understanding of the U.S.S.R.*, p. 164, and N. Vosnesensky, *Economic Results of the U.S.S.R. in 1940 and the Plan of National Economic Development for 1941*, p. 9.

TABLE 58.—PRODUCTION OF IMPORTANT INDUSTRIAL AND AGRICULTURAL COMMODITIES IN SOVIET RUSSIA IN SELECTED YEARS IN COMPARISON WITH PLANNED ESTIMATES

Source: *Results of the Second Five-Year Plan and the Project of the Third Five-Year Plan*, pp. 5, 13. Birmingham, Eng., Birmingham University, Bureau of Research on Russian Economic Conditions and several minor sources.

Item	Units	1913	1928	1932 (actual)	1932 (planned)	1937 (actual)	1937 (planned)	1940 (actual)	1942 (planned)
1. Locomotives.....	Numbers	418	478	828	1000	1681	2800	1000 ^a	2340
2. Goods trucks.....	Thousands	14.8	10.6	20.2	12.6	66.1	118.4	51.0	120.0
3. Motor cars.....	Thousands	0.1	0.7	23.9	105.0	200.0	200.0	194.9 ^a	400.0
4. Tractors.....	Thousands	....	1.2	50.6	55.0	80.3	88.5	....	....
5. Electric power.....	Billions of K.W.	1.9	5.0	13.5	22.0	36.4	38.0	40.1 ^a	75.0
6. Oil.....	Million Tons	9.2	11.7	22.3	21.7	30.5	46.8	34.2	54.0
7. Coal.....	Million Tons	29.1	35.5	64.7	75.0	127.9	152.5	164.7	243.0
8. Pig iron.....	Million Tons	4.2	3.3	6.2	10.0	14.5	16.0	14.9	22.0
9. Steel.....	Million Tons	4.2	4.3	5.9	10.4	17.7	17.0	18.4	27.5
10. Rolled steel.....	Million Tons	3.6	3.4	4.3	8.0	13.0	13.0	13.0	21.0
11. Sulphuric acid.....	Million Tons	157	211	552	1450	1666	2080	....	....
12. Cement.....	Million Tons	1.5	1.8	3.5	6.4	5.5	7.5	5.3	11.0
13. Sawn lumber and timber.....	Million Cubic Meters	11.9	13.6	24.4	42.5	33.8	43.0	....	45.0
14. Paper.....	Thousand Tons	205	284	479	900	892	1000	....	1500
15. Cotton textiles.....	Million Meters	2227	2742	2417	4700	3417	5100	3800	4900
16. Woolen textiles.....	Million Meters	95	93.2	88.7	270.0	108.3	220.0	123.0 ^a	177.0
17. Leather shoes.....	Million Pairs	8.3	29.6	84.7	84.0	164.2	180.0	148.3 ^a	258.0
18. Raw sugar.....	Thousand Tons	1290	1283	1403	1400	2121	2500	162.2	3500
19. Grains.....	Million Metric Quintals	816	733.2	698.7	1037.8	1202.9	1018.0	1190.0	1900.0
20. Cotton.....	Million Metric Quintals	7.4	8.2	12.7	19.1	25.8	21.2	25.2	32.0
21. Flax.....	Million Metric Quintals	3.3	3.2	5.0	6.2	5.7	8.0	6.7	8.5
22. Sugar beets.....	Million Metric Quintals	109.0	101.4	65.6	193.5	218.6	276.0	....	292.0
23. Horses.....	Million Head on Hand	35.8	33.5	19.6	36.9	16.7	21.8	....	21.9
24. Large-horned cattle.....	Million Head on Hand	60.6	70.5	40.7	80.9	57.0	65.5	....	79.8
25. Sheep and goats.....	Million Head on Hand	121.2	146.7	52.1	160.9	81.3	96.0	....	170.7
26. Pigs.....	Million Head on Hand	20.9	26.0	11.6	34.8	22.8	43.4	....	45.6

^a 1939 production.

reach 9.3 millions by 1942.¹³ The total number of workers in state enterprises was 27 millions in 1937 and 30.4 millions in 1940, which may be compared with the total of 11.4 million wage earners in 1913.¹⁴ Russian industrial production was 3.8 per cent of world industrial production in 1929, but 11.0 per cent in 1932, and 15.2 per cent in 1936. It was expected to reach 32.0 per cent in 1942.¹⁵ The average wage per industrial worker was 870 rubles a year in 1928, 1478 rubles in 1932, 3447 rubles in 1937, and 4069 rubles in 1940. The planned average wage for 1942 was 4722 rubles.¹⁶

Rapid progress has also been made in the socialization or collectivization of the Russian economy. In 1928, almost all of the agricultural resources of the country were still in private hands, but by 1937, 98.6 per cent of all agricultural production was carried on by state or collective farms. By 1937, 98.7 per cent of all the non-human means of production in the system had been brought into socialized ownership, 99.8 per cent of industrial production was in the hands of state enterprises, and virtually 100 per cent of the internal commerce of the country was carried on by state or collective enterprises.¹⁷

Results in Terms of Specific Commodities.—In Table 58 we present statistics of the production of several important industrial and agricultural commodities in Soviet Russia in the years 1913, 1928, 1932, 1937, and 1940, together with the planned estimates of production for 1932, 1937, and 1942. It may be noted that the production of most of these commodities had been increased very greatly by 1937, as compared with 1913 and 1928, and that still greater accomplishments were planned for 1942. In some cases, production has exceeded the planned estimates, in others it has fallen a little short, and in still others it has missed the estimates by a wide margin. On the whole, however, the only reasonable comment on these statistics seems to be that they are remarkable, if accurate.

The Elimination of Depressions.—Supporters of the Soviet régime are fond of referring to the U.S.S.R. as “the land without depressions,” and in general its claim to this title seems to have some justification—although some critics are so unkind as to say that the absence of cyclical business fluctuations in Russia indicates merely that the country is in a state of perpetual depression. But whatever the level of economic activity may

¹³ *Results of the Second Five-Year Plan and the Project of the Third Five-Year Plan*, p. 5; and H. Johnson, *The Soviet Power*, pp. 347–349.

¹⁴ N. Vosnesensky, *Economic Results of the U.S.S.R. in 1940 and the Plan of National Economic Development for 1941*, p. 32.

¹⁵ H. Johnson, *The Soviet Power*, pp. 92, 93.

¹⁶ *Handbook of the Soviet Union*, New York, The American-Russian Chamber of Commerce, 1936, pp. 69–70; H. Johnson, *The Soviet Power*, pp. 69, 347–349; and N. Vosnesensky, *Economic Results of the U.S.S.R. in 1940 and the Plan of National Economic Development for 1941*, pp. 10, 32.

¹⁷ M. T. Florinsky, *Toward an Understanding of the U.S.S.R.*, p. 173.

have been in Russia, it seems clear that this activity has not thus far been characterized by any of the business breakdowns which occur at frequent intervals in capitalistic countries.

This does not mean that instability of economic activity is impossible in Russia, and that business depressions or breakdowns could not occur there under any circumstances. It does mean, however, that if the Soviet system is well managed and if the desire to eliminate business depressions is sufficiently strong, Russia is in an advantageous position for maintaining economic stability. She is in a position, as we have seen, to avoid many of the types of waste which ordinarily characterize capitalistic states. Production is planned and controlled by society as a whole through governmental agencies and is not dependent, as in capitalistic countries, upon the decisions of thousands of independent and uncoordinated individuals. As a result, misdirected production should be less likely to occur in Russia than elsewhere. Of course, the planning authorities have to plan production for future markets, and it is likely that mistakes will be made in estimating consumers' needs or demands. However, since they are in a position to control prices as well as other economic matters, it will be possible to prevent such mistakes from clogging the markets with unsalable commodities, especially since it is not necessary in Russia for any particular commodities to sell at profitable or cost-covering prices.

Finally, the conflict between individual and social interests has been minimized in Russia. Economic activity is carried on in the interests of society as a whole, and its object is to produce goods in abundance rather than at a profit. In other words, there are no private enterprisers in Russian industry whose doubts and fears might at times lead them to restrict production, throw laborers out of work, and cut down their purchases of materials and supplies, because of a current or prospective lapse of profits. It is to the interests of Russians as producers to keep the wheels of industry turning just so long as it is to the interests of Russians as consumers to have the goods that are thus made available.

The Employment of Labor.—Russia also likes to be known as "the land without unemployment." Indeed, the national constitution now promises every person a job. In the past, some Russians have been excluded from employment in socialized industries because of their connection with the old régime, but this policy has been discontinued. Certainly, Russia has had but little unemployment in the past. However, it must be noted that there is nothing about the Soviet system which inevitably rules out unemployment. But it seems probable that the planning authorities can prevent unemployment if they devote themselves to the task with wisdom and determination.

In capitalistic societies, laborers are put to work by the business enterprisers, who control the land and capital, only if it appears likely that profits can be made in this way. In the U.S.S.R., laborers work for the

government—that is, for society as a whole—and it is profitable for society to put people to work just so long as human wants remain unsatisfied. In Russia, the question of profit from the employment of labor does not arise in the usual sense. The cost of putting additional laborers to work consists of turning over to these workers certain productive resources which could otherwise be used by laborers already at work. In other words, the cost of employing more labor is the necessity for those already at work to get along at least temporarily with smaller real incomes. But this reduction in real incomes for those previously employed will be merely temporary, unless the population of the country should become too large in comparison with the land and capital at its disposal. And even in this event, it would be both possible and desirable to keep at work all who are capable of contributing to production.

Workers' Gains.—In addition to providing steady work for her people, Russia claims to have benefited the workers in other important respects. The standard working day is seven hours in ordinary occupations, and six hours in dangerous trades and for all workers sixteen to eighteen years of age. The workers have every sixth day off. No employment of workers under sixteen years of age is permitted, except for training. The workers enjoy a full social security program (except that unemployment insurance need not be and is not included), and get annual vacations of two weeks to a month with full pay. Most Russian workers in the socialized economy are members of labor unions of the industrial type, and enjoy wages, hours, and working conditions which are arrived at by collective bargaining. Most workers are on a piecework wage basis, with bonuses for quantity and quality, and assurance that piece rates will not be cut as the workers' earnings rise.

Some of these advantages have been reduced recently, under the stress of emergency conditions arising out of measures for war and national defense, but in general the Russian workers are well off, in view of the limitations of their economic system. This does not mean, however, that their real incomes and standards of living are as high as those of American workers in similar positions. For a small per capita national income, such as Russia's, is pretty certain to result in low real wages and standards of living, no matter how fairly and equitably the national income is divided among the citizens, or how favorable the working conditions may be.

CRITICISMS OF RUSSIAN ECONOMIC PLANNING

Russian Statistics.—It is not intended that this discussion should give the impression that no problems remain unsolved in the U.S.S.R. Actually, the results of the Russian planned economy may be criticized in many ways. In the first place, there is the question of the reliability of the sta-

tistics on production, income, wages, and other matters. Almost the only source of data is the Russian government itself (or various agencies of the government), and this is clearly a biased source. The Russian government, operating a planned economy in the midst of a skeptical world, is doubtless anxious to have its economic affairs appear in a favorable light, and there is a possibility that this government, like other governments, may touch up its statistics at times. Moreover, there is no way to check these statistics adequately, and thus to measure and correct any inaccuracies that might exist.

The Russian government and its agencies sometimes give statistics in terms of "current rubles" and again in terms of "rubles of 1926-27 value." Data presented by different governmental agencies, covering exactly the same economic activities, often vary widely, and attempts are seldom made by these agencies to account for the discrepancies. However, it may be said for Russian statistics that they show both the successes and failures of planned operation, and that they would still indicate a remarkable degree of economic progress over a limited period of time, even if they had to be discounted by a very sizable fraction.

The Rapidity of Industrialization.—Some critics, while conceding that rapid economic progress has been made in the U.S.S.R., are inclined to discount this progress because of the low level of economic activity from which the planned economy started. It is obviously much easier to double a small national income than a large one. An absolute increase which would double the number of industrial workers employed in Russia might cause only a 10 per cent rise in the number employed in this country. It has been suggested that economic progress in Russia under planning has proceeded but little, if any, faster than American economic progress in the early days of this country, if allowance is made for differences in the conditions under which the progress occurred. According to this analysis, economic activity in Russia will expand much more slowly in the future than in the past. As evidence on this point, the critics call attention to the fact that the third Five-Year Plan called for an increase in industrial output of only 92 per cent, as compared with 136 per cent for the first Five-Year Plan and 114 per cent for the second.

Opposed to these critics are others who claim that the process of industrialization has been too rapid, so that waste and inefficiency have resulted. They insist that a more gradual process of industrialization would have produced much better results. The Russian planners have been greatly interested in large-scale enterprises and this interest is said to have interfered to some extent with rapid industrialization. For example, in setting up an electric heat-and-power station in Moscow, the plans called for a giant station with a capacity of 200,000 kilowatts. Construction was started in 1932, but the plant was still unfinished at the end of the second Five-Year Plan in 1937. If the Plan had called for 8 or 10

stations of 20,000 or 25,000 kilowatts each, some of the stations at least could have been in operation by 1937.

Standards of Living.—In 1932, at the end of the first Five-Year Plan, the output of consumers' goods in Russia was estimated at 16.2 billion rubles, and that of producers' goods at 19.1 billion rubles; in 1940 Russia's output of the means of production exceeded her output of consumption goods by more than 56 per cent.¹⁸ Again, it has been estimated that, under the first three Five-Year Plans, Russia will have taken close to a third of her national income in the form of capital goods.¹⁹ If we value the ruble at about five to the dollar, the entire Russian national income of 125.5 billion rubles in 1940 becomes a little over 25 billion dollars for some 170,000,000 people. Russia's extensive program of capital formation, in the face of a national income which is small to start with, calls for sacrifices on the part of consumers. We are not surprised, then, to hear that the average standard of living in Russia is far below that of the United States or Great Britain. However, the average Russian is now probably better fed, dressed, and housed than ever before, even if he is not particularly well off according to American standards.

It may be contended that Russia has not yet given convincing proof of success in adapting planned production to human desires. With the people in sore need of goods of almost all kinds, it has in the past been easy for the planning authorities to direct production so that the goods produced would be wanted by consumers. When Russian productivity has advanced so far that the basic wants of the people have been cared for, the problem of turning out the kinds and quantities of comforts and luxuries that people desire will be a more difficult matter. The real test of planned production in satisfying the desires of consumers is still to come.

Labor Difficulties.—We have seen that the distribution of income in the U.S.S.R. has been controlled in such a way that there is but a slight degree of economic inequality. This control of distribution is quite desirable from several points of view, but incomes must not be made so nearly equal as to destroy individual incentive to efficiency. Why should a laborer work hard and develop maximum efficiency if he will get the same, or very nearly the same, wage as the worker who toils just enough to hold down his job? Will people be anxious or even willing to take difficult and responsible managerial positions in industry if they receive in such posts an income which is only moderately higher than that received by ordinary labor? Will those in managerial and executive positions operate their plants with the utmost efficiency if they can get the same, or almost the

¹⁸ *Handbook of the Soviet Union*, pp. 69, 70; and N. Vosnesensky, *Economic Results of the U.S.S.R. in 1940 and the Plan of National Economic Development for 1941*, p. 14.

¹⁹ E. R. Sikes, *Contemporary Economic Systems*, p. 277.

same, income by operating only efficiently enough to avoid censure or punishment? Will they devise new processes and better methods of production if these achievements cannot result in profit to themselves? Will people of inventive talent exercise their genius if their inventions benefit them only indirectly, through the increased productivity of society? Many people feel that Russia has reduced inequality in the distribution of income to such an extent as to destroy or greatly weaken individual initiative.

On this important point there is as yet no conclusive evidence. It apparently is true, as is frequently alleged, that the Russian system has been slow to show improvements in the efficiency or productivity of workers. Great increases in physical productivity have occurred, but it is held by some that quality has not been significantly improved, nor have costs of production been greatly reduced from their extremely high original levels. Increased production has apparently resulted from the use of larger and larger quantities of the productive agents, rather than from greater efficiency in the operation of existing facilities. The efficiency of Russian workers, using similar equipment, has been variously estimated at one-half to one-fourth that of American workers, and the waste of materials by Russian workers is said to be excessive.

The planning authorities are aware that Russian labor is often inefficient, and have taken steps to remedy the situation. Bonuses and premiums of cash or scarce commodities, publicity, public honors, and other devices have been used. Some workers have been made heroes of labor, which rank entitled them to extra cash, free street-car service, low taxes and rents, larger pensions, and superior living space, but the problem is not yet solved. If the difficulties are temporary in character, they may perhaps be attributed to the rapidity of industrialization in Russia and to the fact that millions of people with no previous industrial experience have been trying to learn quickly the operation of modern industrial equipment. But if they should prove to be permanent in character, they may indicate the existence of a serious defect in the Russian scheme of things.

The Question of Individual Freedom.—Finally, if economic progress in Russia continues, and her people are eventually better off in a material sense than the citizens of other countries, there will always be some to say that the Russian citizens have purchased economic welfare at too high a price. In Russia the interests of the individual have been largely subordinated to those of society. Economic activity has been regimented and controlled by the government. The institution of freedom of enterprise, cherished in capitalistic countries despite the fact that it means little to many citizens of these countries, has been done away with in the U.S.S.R. Competition, which is often called the life of trade, is no more. The chance to start out poor and wind up rich does not exist. Under such

conditions, say the rugged individualists, life would not be worth the living for anyone with ability and initiative, despite the assurance that the government would provide a fairly good real income. This question of the relative merits of individual freedom and economic welfare is, of course, one which every person must answer for himself. And in the case of many persons, the decision will doubtless be withheld until they are in possession of more complete information regarding the long-run success of the Soviet movement.

1. What is the importance, to students of economics, of examining the operation of the Russian planned economy?
2. Explain the organization of the Communist Party, and its importance in Russian political and economic affairs.
3. Outline the governmental organization of the U.S.S.R.
4. Is the government of the U.S.S.R. really as democratic as its constitution suggests? Explain.
5. How are economic activities planned in Russia?
6. Why is it often said that Russia has a "two-way" system of economic planning?
7. Distinguish between the functions of plants, trusts, and administrations in Russian industry.
8. Is the relationship of prices to costs of production a significant one in the Soviet economy? Explain.
9. Are there reasons for expecting that planned production can be adapted to the wants of consumers in Russia? Explain.
10. How does the status of agriculture differ from that of industry in the U.S.S.R.? Explain.
11. How do state farms, collective farms, and individual peasant farms differ in organization, operation, and importance?
12. What are the factors which determine the amount of income which a worker on a collective farm will receive in a given year? Explain.
13. As a Russian farm worker, would you prefer to be on a state farm or collective farm? Why?
14. How are existing supplies of land and capital apportioned among the various industries in Russia?
15. How is the total volume of saving and investment, in terms of physical units, controlled in the U.S.S.R.?
16. How are financial results made to match the physical results in connection with the process of saving and capital formation?
17. Why is it true that the cost of obtaining capital goods is the same in Russia as in any other type of economic system?
18. On what basis is the Russian labor supply distributed among occupations and industries?
19. Why are differences in wages permitted among workers in Russia?
20. How great are these wage differences? Explain.
21. Explain the various ways in which consumers' goods have been distributed among the consumers in Russia.
22. What progress has the Russian economy made toward its goal of having a single set of merchandising units selling to all purchasers at a single scale of prices?

23. How is international trade handled by Soviet Russia?
24. How does the monetary problem in Russia differ from that faced by the governments of other countries? Explain.
25. Give a general estimate of the results of planned operation in the Russian economy.
26. "The rapid industrialization of the U.S.S.R. may be considered either as an advantage or a disadvantage." Explain.
27. Is Russia "the land without depressions"? Why?
28. Why is it difficult to evaluate the economic accomplishments and failures of the U.S.S.R.?
29. Have Russian consumers benefited greatly under the planned economy up to the present time? Explain.
30. What labor difficulties does Russia still have to contend with? Explain.
31. "The evaluation of the Russian economy depends in part on the issue of individual freedom *versus* economic welfare." Explain.

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seems to serve no very useful purpose. Members of the Senate, even before fascism, were appointed by the King on recommendation of the Prime Minister, and this procedure has not been changed under the new system. An elected body, the Chamber of Deputies, or lower house, was retained for a time, but the method of its election was changed in 1928. Candidates for the Chamber of Deputies were nominated by the Grand Council of the Fascist Party, and the people had to vote for these candidates or not at all. However, in 1938, the Chamber of Deputies was supplanted by the Chamber of Fasces and Corporations, a body of 650 members selected from the National Council of the Fascist Party and the National Council of Corporations.

The legislature lacks the power to initiate legislation, considers only the business suggested to it by high party officials, and meets only to approve promptly and automatically the acts and policies dictated by Mussolini. Even this approval has little significance, for the Cabinet has the power to make laws by decree subject to legislative approval within two years. Apparently, the chief function of the legislature is to approve acts and policies already adopted by Mussolini.

The Grand Council of the Fascist Party has the power to draw up a list of candidates to succeed Mussolini when a successor becomes necessary, and the King will select the successor from this list, which might contain only one name. Thus, it is intended that control of the government shall remain in the hands of the Fascist Party even after Mussolini has passed from the scene. Provincial and local government officials, like the high officials of government and economic life, are ordinarily fascists, and are appointed by the Minister of the Interior, who is Mussolini himself.

The Fascist Party.—Italy and Russia have been alike, also, in having a one-party system of government. In Italy, no political parties or organizations are tolerated except the Fascist Party, which now has a membership of some 3,000,000 adults. Except by special permission from above, the party does not accept new adult members. Instead, it relies upon the development of new members from the junior fascist organizations. Both boys and girls are members of youth organizations, which include groups aged 6 to 8, 8 to 14, 14 to 18, and 18 to 21 years. Several millions of budding fascists are found in the various youth organizations.

The Secretary of the Grand Council nominates, and Mussolini appoints, the Secretaries of the Provincial Federations of the Fascist Party. In like fashion, district and local party officials are appointed from above, so that control over the party organization is maintained directly from top to bottom. The principal requirement for membership in the Fascist Party appears to be a willingness to obey Mussolini's orders without question and a determination to serve the party's cause without reservations. As in the case of the Communist Party in Russia, members of the Fascist Party

are carefully watched after being admitted to membership, and may be called to account at any time if they fail to exhibit the prescribed fascist virtues.

Individual Liberties.—Italy under fascism is like Russia in that the rights and liberties of the Italians as individuals have been almost entirely destroyed. Fascism has a profound distrust of democracy, and feels that democratic institutions are out of place in a truly modern state. Ordinary individuals are considered too ignorant or too thoroughly immersed in the private affairs of life to carry on the affairs of government successfully. This task must be undertaken by the chosen few, who are found in the Fascist Party. The right of free assembly is denied except to fascist organizations. All newspapers and other publications opposed to the rise of fascism have been ruthlessly suppressed. The publications that remain print only what they are told to print. Freedom of the press is a meaningless term in Italy. Freedom of speech is also practically non-existent there. Any criticism of, or opposition to, acts and policies of the government or of the Fascist Party is likely to be interpreted as treason. Those accused of such political offenses are tried by fascist judges, and are often not even granted the right to hire lawyers to represent them. Education is rigidly controlled by the government for the purpose of perpetuating the fascist régime. Not only is opposition to fascism viewed as a kind of social disease which must be eradicated as quickly as possible, but the favorite method of eradication is that of violence. Sluggings, beatings, and other forms of mob violence, as well as overdoses of castor oil for those who fail to see the light of fascism, have done much to discourage outward show of opposition to fascism.

The Individual and the State.—Though both Italy and Russia have had very strong central governments to which the individual has been subordinated, there are in this connection two important points of difference between the countries. In Russia, the dictatorship has been that of the proletariat (industrial workers) or of the Communist Party in the interests of the proletariat. Fascism in Italy, in its formative stages, was supported largely by landowners, industrialists, and the middle classes in general. Indeed, socialists and communists usually look upon fascism as an instrument for controlling and suppressing the workers in the interests of the owning classes.

There is reason to believe that the early supporters of the movement were granted favors in return for their assistance. As one writer puts it, "Business men and landlords were released from annoyances to which they had recently been subjected. Capital issues were freed from taxation, the official commission of inquiry charged with discovering illicit war-profiteering was dissolved and its findings suppressed, and the family inheritance tax was abolished. Wherever possible, indirect taxes were substituted for direct. The decrees that provided for cession of land to

cooperatives were repealed, and peasants were ousted from estates that they had occupied. A proposed law for division of the *latifondi* (large landed estates) was dropped, and the measures limiting rises in land rents and evictions of tenants were revoked. Financial support was withdrawn from workers' cooperatives. . . . Most of the telephone system was handed over to private enterprise, and motions were even made to end State control of the railways, post offices, and telegraphs. The Government ceded its match-monopoly and its life-insurance business to private interests. The economic activities of municipalities were curtailed."¹

The second point of difference between the centralized control in Italy and Russia is this: The individual in Russia has been subordinated to the state for his own good, because it was thought that this was the way in which the greatest good would come to the greatest number. In Italy, however, the individual has been subordinated to the state for the good of the state. The state is thought of as something more than an aggregate of the individuals who make it up at any particular time. "For fascism, society has historical and immanent ends of preservation, expansion, and improvement, quite distinct from those of the individuals which at a given time compose it; so distinct in fact that they may even be in opposition."² Individuals are regarded as merely the means by which society may reach its goal, and as but temporary and relatively unimportant elements in the long life of the state.

Moreover, the individual cannot exist without the state. Apart from the state the individual has no more purpose or reason for being than has one body cell isolated from the human body. For the individual to assert his rights against the state would be as ridiculous as for a body cell to rebel against the body as a whole. Thus, the individual has no rights which are superior to those of the state. He has merely a duty toward the state and, in performing this duty, he may be expected to sacrifice everything, even life itself. The interests of the state permeate all activities of the individual, and not merely his political activities. This general theory explains why the rights of individuals, as we are accustomed to view them, are largely suppressed in Italy. The fascist theory of the state is seen in action in the economic policies of fascism, most of which are intended to promote the greater glory of Italy, rather than the welfare of the individual citizens of that country.

ECONOMIC POLICIES OF ITALIAN FASCISM

The Question of Economic Planning.—In the early years of fascism, Italy had a hybrid type of economic system. It could scarcely be con-

¹ C. T. Schmidt, *The Corporate State in Action*, New York, Oxford University Press, 1939, pp. 51, 52.

² Julia E. Johnsen, compiler, *Capitalism and Its Alternatives*, New York, H. W. Wilson Company, 1933, p. 376.

sidered truly capitalistic, and yet it did not adopt full-fledged economic planning. Some writers say that a nation engages in economic planning whenever the government interferes with and controls economic activity to any considerable extent. In this sense of the term, Italy did engage in economic planning, for the government exercised a considerable degree of control over economic activity. However, if true economic planning involves drawing up detailed plans for all departments of economic activity over a considerable period of time, with supplementary detailed estimates of proposed achievements in individual years, Italy did not have economic planning. In other words, if Russia provides an example of a planned economy, Italian economic activity was not planned but merely partly controlled by the government.

In Italy—contrary to the situation in Russia—land and capital are largely owned by private individuals who, without working, may receive incomes in the form of interest or rent, though state officials sometimes dictate the uses to which these agents of production are to be put. Instead of having all branches of economic activity directed by the state, fascist Italy claims to recognize that private initiative in production is an effective and economical instrument for getting things done. However, those who direct economic activity are said to be responsible to the state, for the interests of the state are supreme. The state presumably interferes in the field of production only when private initiative is lacking or inadequate, or when the interests of the state are so directly concerned as to make governmental control imperative. Interference by the government may take the form of encouragement, general supervision, or outright management.

Fascists are said to be proud of the fact that fascism has had no general program, save that it aims to promote the greatness of Italy. Fascism has concentrated upon action, rather than theory. According to Mussolini, fascism as an idea is indefinable. It is a fact which is taking place. Fascism originally did not have the instruments for economic planning in a comprehensive sense, and only Mussolini had the power to plan in any real sense of the word. His policies in controlling economic activity were sporadic and likely to affect only certain phases of economic life at any one time. Thus, in time of emergency, Mussolini would order certain essential industries to run day and night until further notice, in order to increase production. At other times, when he decided that it was desirable to maintain the Italian monetary unit, the lira, at an artificially high value in terms of the currencies of other countries, he would order a general reduction in prices and wages throughout Italy, and see to it that the order was enforced.

To be sure, in spite of friendly gestures toward private enterprise, the Italian government owned and operated the railroads, much of the shipping industry, the post office, the telephone and telegraph business, and the industries that sold salt and tobacco. This, however, was a far cry

from the situation in Russia, where practically all industries are owned and operated by the government. Mussolini was able, also, to achieve a crude sort of control over the kinds and quantities of economic goods produced in Italy, by taking over the investment banking activities of the country. The credit of the government was made available for enterprises and industries which Mussolini thought worthy of encouragement, while other businesses were required to work out their own salvation.

The Making of Economic Decisions.—But when all is said and done, it must be evident that economic activity in Italy was to a considerable extent unplanned in the early years of fascism. Private individuals owned land and capital, and could turn over these agents of production to any enterpriser on the basis of the rate of return that was offered. Individuals were left free, for the most part, to save or not to save, on the basis of the usual economic incentives. Private enterprisers in many cases still decided for themselves what to produce and in what quantities, and were free to operate their enterprises at capacity, part capacity, or not at all, in the absence of specific orders from the government. Individuals as consumers were free to spend their money incomes in any way which seemed desirable, and producers had to rely upon the willingness of consumers to purchase their products at prevailing prices. While the government frequently interfered in these various phases of economic life, the individual was assumed to be free unless and until he was specifically interfered with, while in Russia it is assumed that the government controls and directs all economic life in the absence of specific information to the contrary.

Business Depressions and Unemployment.—Under the conditions just described, Italy was not in so favorable a position as Russia with respect to business depressions and unemployment. Since the control of production in Italy was left to private initiative in cases where the interests of the state were not likely to suffer, and since private individuals had a stake in the profitable operation of industry, it was to be expected that Italian enterprisers would vary their rates of production in accordance with business conditions and the prospect of profit or loss, when not under specific orders from the government. Since most businesses in Italy were relatively small-scale enterprises, it followed that decisions in the field of production, when not made by the government, were made by a considerable number of independent individuals. Hence, the Italian system could hardly be expected to avoid the competitive wastes which characterize capitalistic economic systems, and the cumulative mistakes which are so potent a factor in bringing about periodic business breakdowns or depressions. Moreover, since the Italian monetary unit was kept on a gold basis for a long time under fascism, the Italian economy was troubled by international influences when business was depressed in other countries.

Italy, like the United States and other capitalistic countries, suffered heavily in the great depression that began in 1929, and had a serious vol-

time of unemployment; for the basic means of production were privately owned and the workers had to depend upon the owners for jobs. Except in industries controlled by the government, Italian business leaders, like capitalistic employers elsewhere, employed labor when it appeared that a profit could be made, and refused to employ it when business conditions seemed unfavorable. When a government plans and directs all economic activity, there can be plenty of jobs for workers so long as human wants remain unsatisfied, but this was not the case in Italy.

As industrial production fell from an index number of 109.2 in 1929 to 73 in 1932, and unemployment rose from 300,000 in 1929 to over 1,000,000 in 1933, the Italian reactions to depressed business conditions were those of a capitalistic and not a planned economy. Public works programs were set up, hours of labor were shortened in order to spread the work, and the movement of workers within the country was severely limited. Two governmental agencies, the *Sofondit* and the *Istituto Mobiliare Italiano*, were set up to advance credit to private companies on the strength of the stocks and bonds of these companies, with the governmental agencies recovering their funds by selling other securities of their own. Italy even had an *Istituto di Ricostruzione Industriale*, similar to the American Reconstruction Finance Corporation, to liquidate bankrupt concerns, furnish financial aid to enterprises through long-term loans, and supervise the financial reconstruction of business.

The Controlled Economy.—It was widely predicted of the Italian economy that it could not go on being partly controlled and partly free. Such a system would be likely to suffer the disadvantages of both the capitalistic and the controlled types of systems, while enjoying the advantages of neither to the full. In recent years, under the influence of the post-1929 depression, the Ethiopian conquest, and preparation for and participation in the second World War, Italy has adopted virtually complete governmental control over economic activities. However, the ownership of land and capital and the actual operation of industry remain very largely in private hands. Moreover, the apparent objective of governmental control is to further the interests of the state rather than to advance the economic welfare of the individual.

Employer-employee Relations.—While the Italian government under fascism does not directly control the distribution of the national income among landowners, capitalists, enterprisers, and workers, the relations of capital and labor are controlled by a somewhat complex system under governmental supervision. The general outlines of this system are set forth in the *Charter of Labor*, which was enacted in 1927 and is regarded by fascists as a kind of constitution for the development of the fascist ideal known as the Corporate State. Under the provisions of the *Charter of Labor*, wages, hours, and other working conditions are fixed by collective contracts between workers' and employers' syndicates.

The Syndicates and Federations.—The syndicate is the basic unit for

the conduct of employer-employee relations. The state permits only one syndicate for each industrial category of workers or employers in a geographical unit; and syndicates of workers must be separate from those of employers. A workers' syndicate may be formed by as few as 10 per cent of the workers in an industrial category in a given locality, and, if approved by the government, may make contracts for all the workers. In like manner, an employers' syndicate may be formed by enterprisers who employ at least 10 per cent of the workers in an industrial category in a given locality, and who comply with certain other specified conditions. Labor contracts drawn up between these opposing syndicates are binding on all workers and employers in an industrial category, and non-members as well as members must pay dues to the syndicates. By the end of 1936, 16,026 provincial and 1420 interprovincial and national collective agreements or contracts had been made. In addition to drawing up labor contracts, the syndicates administer maternity benefits, vacations, social insurance, medical attention, and other matters.

Local syndicates of employers and employees form into federations at the provincial level, and so on up to national federations under the supervision of the National Council of Corporations and the Ministry and Minister of Corporations. All employees come under one or another of the great national employees' federations for industry, agriculture, commerce, banking and insurance, and professions. All employers belong to similar national employers' federations, except that there is no employers' federation to match the federation for professional workers, since these workers usually employ themselves.

The Labor Courts.—We have said that wages and working conditions are determined by labor contracts drawn up between syndicates of workers and employers, but there remains the problem of handling disputes between employees and employers as to the interpretation of an existing labor contract, or the desire of one group or the other to introduce new conditions which the other party does not favor. Fascism recognizes that there may be conflicts of interest between employers and employees, but it is determined that these conflicts shall not result in a cessation of production which might injure consumers and the interests of the nation as a whole. Consequently, under the Italian system, workers and employers are forbidden, under severe penalties, to engage in strikes and lockouts, or use any of the other weapons—described in Chapter 23—which employers and employees in most countries employ in attempting to enforce their demands.

When a *collective* dispute of some importance arises, an attempt is made to bring workers and employers together through conciliatory agencies. If conciliatory measures fail (though they usually do not), the controversy goes to the labor courts which have been set up in sixteen districts throughout the country. Disputes between individual employers

and workers are often decided by local magistrates or justices of the peace, but they too may be taken to the labor courts in some cases. Each labor court is composed of three judges, assisted by two experts, one on labor problems and the other on production. Decisions are rendered both on the basis of law and precedent, and in consideration of the interests of consumers and of the nation as a whole. Thus, the interests of both employers and employees are supposed to be subordinated to those of society.

The Results of the Fascist Labor Policies.—There is a general impression that the fascist method of handling employer-employee relations is likely to work to the disadvantage of labor. Under the system, workers and employers are given equal rights of organization, and both are deprived of their usual weapons of industrial warfare. This equal treatment might be ideal if the two classes had equal bargaining power in the first place. But since, other things being equal, employers are much superior to their workers in bargaining power, it would seem that the employers clearly hold the upper hand under this system of "equal treatment" for capital and labor.

The syndicates are actually governmental organizations, instead of organizations of employers and employees. The workers and employers are members of the syndicates, but the syndicates themselves, their officers, their activities, and the collective agreements into which they enter, are all subject to governmental approval through the Ministry of Corporations. The officers of the syndicates are usually fascists of standing—"Blackshirts appointed by the government to direct the syndicates."³ They are almost all of middle-class origin, and are governmental representatives rather than representatives of employers and employees. The collective agreements are contracts between workers and employers, but their content is largely controlled by Fascist Party policy and not by genuine collective bargaining.

The two experts who assist the three judges in each labor court must be university graduates, and are not likely to be strongly biased in favor of the workers. Moreover, the labor courts are not independent judicial agencies, for their verdicts must fall in line with party policies. In the period 1926-36, 145,289 labor disputes reached courts of one kind or another. Of these cases, only 34 involved the labor courts proper. Only 14 cases were decided by verdicts of the labor courts, the other 20 being settled by their conciliatory efforts.⁴ Official reports indicate that court decisions favor the workers in labor disputes, but this conclusion should be taken with a grain of salt, for none of the decisions have required employers to raise wages. What often happens is that employers demand a con-

³ C. T. Schmidt, *The Corporate State in Action*, p. 76.

⁴ W. G. Welk, *Fascist Economic Policy*, Cambridge, Harvard University Press, 1938, pp. 84, 85.

siderable cut in wages, the workers refuse to take so large a cut but propose a smaller one, and the appropriate court fixes the actual wage decrease at or near the level suggested by the workers. The outcome is then hailed as another "victory for labor." Well might Mussolini tell the president of the Confederation of Industrialists, "I assure Signor Benni that so long as I am in power the employers have nothing to fear from the labor courts."⁵

The Corporations.—Governmental control over the basic processes of production and distribution is obtained in part through agencies known as "corporations." The corporations were provided for in laws of 1926 and 1927, but with one exception did not actually come into existence until 1934. Since then there have been twenty-two of these corporations, divided into agricultural, manufacturing, and service groups. The eight corporations under the heading of agriculture include grains; vegetable, flower, and fruit-growing; viticulture and wine production; edible oils; sugar beets and sugar; animal husbandry and fishing; wood and wood products; and textile products. The eight corporations under manufacturing deal with building and construction; metallurgy and machinery; clothing; glass and ceramics; chemicals; paper and printing; extractive industries; and water, gas, and electricity. The six corporations under service control professions and arts; internal communications; sea and air transportation; tourist and hotel trade; credit and insurance; and theater and public entertainment.⁶

Unlike corporations in America, the Italian corporations are not productive units. They have no plants, employ no workers, and produce no commodities. Each corporation is a kind of national board of directors for the industries which fall within its division—that is, an organization of men set up to control a major branch of economic activity. The corporation is composed of representatives of the Fascist Party, and representatives of the employers' and employees' syndicates in all the industries which come under its jurisdiction. The Minister of Corporations (Mussolini) is nominally president of each corporation, but one of the other party representatives actually functions in this capacity in his place.

The Functions of the Corporations.—The corporations, as agencies of economic control, have several functions. They furnish the government with information and advice on economic matters, attempt through their conciliation boards to settle labor disputes which cannot be disposed of by collective negotiation between employers' and employees' organizations, and help prepare detailed plans for national economic self-sufficiency. However, the most important function of the corporations, from the point of view of economic control, is the establishment of groups of regulations (similar to the former N.R.A. codes in the United States) for their re-

⁵ C. T. Schmidt, *The Corporate State in Action*, p. 94.

⁶ W. G. Welk, *Fascist Economic Policy*, pp. 109-116.

spective fields of production. These regulations deal with such matters as the determination of fair trade practices, production control, and the fixing of prices and rates. The sets of regulations are nominally subject to the approval of the National Council of Corporations, which is made up of the councils of the individual corporations. Actually, they are approved and controlled by the Central Corporative Committee (composed of the important cabinet members, high party officers, and high officials of workers' and employers' organizations) and the Minister of Corporations. Since the regulations set up by corporations are binding on actual productive establishments, and since the regulations must be approved by high governmental agencies before becoming effective, it is clear that the corporative set-up furnishes an opportunity for highly centralized control over economic activity.

Wages Under Fascism.—A glance at wages under fascism indicates that the labor policies have not turned out very well for workers. One or more wage cuts occurred in each year from 1927 through 1931, with occasional wage adjustments thereafter, so that by 1934 it was estimated that the average money wage in industry was 30 to 40 per cent below the 1926 level. Prices and the cost of living were also falling over this period, but not so fast as money wages. The decline in real industrial wages was about 20 per cent.⁷ Similar declines occurred in agricultural wages. In 1936 and 1937 money wages rose at intervals, but not so rapidly as prices.

Social Insurance.—The Italian workers receive several kinds of social insurance and other benefits. All workers have insurance against industrial accidents and diseases, including tuberculosis, and are entitled to old age pensions. Many are insured against unemployment as well. Supplementary wages are sometimes paid to workers with large families, and women workers receive maternity benefits. The government sponsors a number of social welfare agencies, including the famous *Dopolavoro*, or after-work organization, which provides vacations, sports, education, and recreation for member workers. In general, the Italian system of social insurance is scarcely satisfactory. In most cases the benefits are small, they continue for very limited periods of time, and are hedged about with numerous restrictions. The contribution of the government to social insurance funds is small, and these funds are frequently diverted to other governmental purposes.

Price Controls.—The control of economic life in fascist Italy includes extensive price-fixing. After a period of declining prices from 1927 to 1934, prices began to rise rapidly. In 1935, the index of wholesale prices rose from 280.2 in January to 355.7 in November, on the basis of a 1913 index of 100.⁸ Late in the same year a Central Price Committee was set

⁷ C. T. Schmidt, *The Corporate State in Action*, pp. 80-82.

⁸ H. S. Miller, *Price Control in Fascist Italy*, New York, Columbia University Press, 1938, p. 36.

up to control prices, and prices remained relatively stable until Italy devalued the lira in October, 1936. Under price control, wholesale prices rose only about 10 per cent in the next six months, though the devaluation of the lira had amounted nominally to 40 per cent. In April, 1937, the control of prices was turned over to the Central Corporative Committee, but wholesale prices rose another 7 per cent by February, 1938.⁹ In more recent times, definite information on Italian economic affairs has been difficult to obtain, but prices have probably continued to rise under war conditions.

Business Combinations.—An increase in the size of Italian industrial units and the formation of many large combinations have also made for ease of economic control. Italy has been known in the past as a land of small-scale industrial units, but that description no longer holds. Between 1927 and 1932, the 465 combinations which were formed caused the disappearance of 1242 firms and involved a total capitalization of 23 billion lire. By 1935, one-fourth of the Italian corporations controlled about 95 per cent of corporate capital, and 118 firms (one-half of one per cent of the total number) controlled 48 per cent of all stock-company capital. Similar trends have been noted in public utilities and finance.

Economic Self-sufficiency.—One of the famous aims of Italian fascism has been to attain economic self-sufficiency. After the lira was stabilized in 1927 at a value which was artificially high in terms of foreign currencies, Italian goods were too high in price to attract foreign purchasers and Italy had great difficulty in maintaining her export trade. Later her invisible exports (such as emigrants' remittances and tourist expenditures) also declined, and it was next to impossible for Italians to pay for the customary volume of imports. Added to the difficulties of international trade and exchange was Italy's wish to be independent of foreign countries for supplies of essential materials, which led her to adopt a program of economic self-sufficiency. Italy is in a very poor position to follow a program of this kind, because of her limited supply of poor, worn soil, her very limited natural resources, and her large population. Within an area only about three-fourths as large as the State of California, Italy has a population of 43,000,000, or about one-third the population of the United States. Though Italy has fair supplies of building materials, sulphur, mercury, aluminum, zinc, and lead, she lacks iron, coal, petroleum, copper, chromium, tin, manganese, and nickel.

The Battle of the Wheat.—The Italian self-sufficiency program involves two elements. On the one hand, Italy has tried to increase the production of commodities insufficient for domestic consumption, and on the other hand she has tried to provide substitutes for materials which could not be produced naturally within the country. Typical of the first part of the program was the famous "Battle of the Wheat," as Italy called her

⁹ *Ibid.*, p. 97.

campaign to increase wheat production. Within a few years, she greatly increased her output of wheat, and announced that it was no longer necessary to import this grain.

While Italy carried on a large-scale land reclamation program, wheat production was increased primarily by raising the yield of land already in cultivation. The government encouraged the use of fertilizers and farm machinery, induced farmers to plant selected seed-wheat, obtained price reductions for chemical fertilizers and fuel for tractors, carried on research, and furnished technical aids. An intensive propaganda campaign was also carried on. However, the chief factor in increasing wheat production was the high price which the government succeeded in maintaining. Very high tariff duties were placed on wheat, wheat derivatives, and wheat substitutes. The duty on wheat itself was as high as 75 lire per quintal (3.7 bushels), or more than \$1.00 per bushel. Regulations required the use of minimum percentages (sometimes as high as 99 per cent) of home-grown wheat in flour-milling.

The victory was costly to the Italian people, since it raised the prices of all wheat products, and in turn decreased the consumption of such products by about 15 per cent between 1925 and 1935. The total cost of wheat to the Italian consumers increased by some 32,000,000,000 lire over the same period.²⁰ The high prices of wheat and related products seem to have unbalanced Italian agriculture. Farmers abandoned the fruits, vegetables, nuts, grapes, and livestock, for which much of the land is suited, and turned to wheat-growing. Decreased imports of wheat were offset by decreased exports of fruits, oils, and wine, and by increased imports of meat; so that some observers feel that there was scarcely any net gain in the matter of international trade, while standards of living definitely suffered. Similar results were obtained in other parts of this phase of the self-sufficiency program.

The Development of Substitutes.—In carrying out the second part of the program, Italy makes synthetic rubber, ersatz wool from milk casein, and cellulose and paper stock from wheat straw; and uses rayon and hemp in place of wool, cotton, and jute; alcohol mixtures for motor fuel; castor oil as a lubricant; cadmium for copper; and electric power in place of coal in railway transportation. The artificial substitutes are usually poorer in quality and higher in price than the natural products which they replace. Their production requires expensive plant and equipment, and funds for this purpose must often be taken from other industries. Products used in new ways—such as castor oil for lubrication—are frequently poor substitutes for the articles which would normally be used. On the whole, then, a self-sufficiency program has little to recommend it from the economic point of view, for it flies in the face of all that is

²⁰ E. R. Sikes, *Contemporary Economic Systems*, New York, Henry Holt & Company, Inc., 1940, p. 427.

known about the benefits of geographical specialization and exchange of products. In Italy, it is conducted primarily for military reasons and not for economic advantages.

The Population Policy.—The fascist population policy, like the self-sufficiency program, is in conflict with the interests of individual Italians as consumers. It can be justified only as another means of carrying on war, which the Italian leaders consider both necessary and desirable. Italy has about 350 persons to the square mile, and the pressure of population on land resources is said by Mussolini to justify his claims of territorial expansion. However, Mussolini apparently feels the need of men for military purposes, and is doing everything within his power to encourage births and discourage emigration.

In an attempt to increase the birth rate, Italy encourages mass marriages, or marriages of large numbers of men and women at showy public services. Cash bonuses for marriages and other cash prizes for large families are offered by the government. Married men are given first chance at government jobs and preference in obtaining housing. Married men with large families are exempted from income taxes and certain other taxes. Young married couples in poor circumstances are granted government loans to set them up in housekeeping, and the government stands ready to cancel 10 per cent of the loan for each child that is born to a couple. Bachelors must pay heavy taxes to retain their single-blessedness, and an income tax which is 25 per cent higher than that for married men. Even illegitimate children are welcomed, cared for, and given full rights. Italian municipalities have taken part in the program by running baby derbies, and by giving medals, diplomas, low street-car rates, low public utility rates, and cheap housing to the parents of large families.

It is difficult to assess the results of this population policy. It is true that the birth rate decreased as much in fifteen years under fascism as in the preceding fifty years, and that the ratio of births to deaths has been decreasing. In 1922, the birth rate was 30.8 per thousand and the death rate 18.1, leaving an excess of births of 12.7. In 1937, the ratio was 22.9 to 14.2, with an excess of births of 8.7.¹¹ Clearly, the fascist policy has not succeeded in producing an increased rate of population growth.

Fascist Militarism.—Another outstanding feature of fascism is its strongly militaristic attitude. It is the fascist policy to keep Italy armed to the teeth. The armed forces are very large in proportion to the population, and their maintenance places another heavy burden upon the citizens as consumers. Children begin to receive military training almost as soon as they are able to walk, and are trained to expect and desire warfare. Mussolini has hurled countless warlike threats and challenges at prospective enemy countries, and Italy has been almost continuously at war since her Ethiopian invasion in 1935.

¹¹ W. G. Welk, *Fascist Economic Policy*, p. 183.

Public Finance.—The Italian government had been operating at a deficit when the fascists took over in 1922. Under the new management, there was a surplus of revenues over expenditures from 1924 to 1930. More recently, the combination of business depression, the self-sufficiency program, the armaments program, and war has again reversed the government's financial situation. In 1940, Italy's revenues were 32.4 billion lire and her expenditures 60.4 billion lire, with a deficit of 28.0 billion lire. The following year was much worse, with expenditures of 96.0 billion lire, revenues of 31.0 billion lire, and a deficit of 65.0 billion lire.¹² The Italian national debt is believed to have more than doubled, for it rose from 95 to 180 billion lire in the first fifteen years of fascist rule.

The Italian revenue system has been changed so that taxes bear more heavily on people of small income. As expenditures have mounted, the levies of the governmental monopolies have increased, customs duties have risen, and heavy taxes on consumption have been imposed. The income tax yields only about 20 per cent of the government's tax revenues, and has the added disadvantages of beginning with very small incomes and providing comparatively low rates on incomes in the higher brackets. In 1936, real estate owners were compelled to subscribe to government bonds to the extent of 5 per cent of the value of their properties. In 1937, a 10 per cent capital levy was applied to the capital and reserves of joint-stock companies, and in 1938 a similar levy was made on the capital of industrial and commercial firms other than joint-stock companies.

The Results of Fascism.—As we have seen, most of the policies of Italian fascism are intended to increase Italy's greatness and prestige among the nations of the world rather than to enhance the economic welfare of Italian citizens as consumers. There is no doubt that the economic welfare of the individual Italian has decreased under fascism. Wages and standards of living in Italy were always about as low as any in Europe, but they have fallen to undisputed last place under fascism. Even in 1929, a fascist deputy in an unguarded moment of parliamentary debate declared: "Our ration is perhaps the lowest in all Europe."¹³ A serious decline has occurred in both the quantity and quality of food consumed. Between 1926 and 1935, consumption declined 15 per cent in wheat, 10 per cent in meats, 15 per cent in olive oil, 6 per cent in butter and lard, 21 per cent in sugar, and 11 per cent in fruits and vegetables. Wine consumption fell off sharply, and declining sales of salt suggested that less cooked food was being eaten. Tobacco sales fell 20 per cent between 1928 and 1935, and furniture sales by 33 per cent in roughly the same period.¹⁴ These changes, while serious enough, were only in *average* con-

¹² *Foreign Commerce Weekly*, January 25, 1941, p. 145, and May 10, 1941, p. 235.

¹³ C. T. Schmidt, *The Corporate State in Action*, p. 90.

¹⁴ *Ibid.*, pp. 90, 91.

sumption. Consumption by the poorer classes must have declined even more drastically.

Of course, it may be argued on behalf of fascism that it "works." The Italian people are quiet, they work without strikes, they eat quite regularly, and those in control of the economic system are presumed to act solely for the best interests of the citizens. However, as an English writer puts it: "In England we have places in which the food comes regularly, where the people are quiet, where they work without strikes, and where those in control act solely for the best interests of those whom they control. We call those places prisons. They are said to be good for the prisoners; but the prisoners are not asked for their view!" Fascists tell us that other countries, like the United States, have much to learn from fascism. This may be true in a negative sense. It is quite possible that the lesson to be learned from fascism is not what to do, but what *not* to do, about our economic problems.

THE GERMAN GOVERNMENT UNDER NATIONAL SOCIALISM

Germany is another great country which is now operating under a system of fascism, though the German system is officially called Nazism or National Socialism. It would be a mistake to think that National Socialism is an exact replica of Italian fascism, but it resembles the latter in many external features and is more like fascism than any other system. We shall point out some of the essential similarities and differences of the two systems in describing National Socialism.

The German Dictatorship.—The present German system is like the Italian in that it has a very strong central government which exercises rigid control over all the activities of individual citizens. The head of the government is Adolf Hitler, who was appointed to the office of Chancellor (Prime Minister) by President von Hindenburg in 1933. Since that time, Hitler has in fact been the supreme dictator or "leader," as he is called, of the German people. However, whereas in Italy the fascist system has retained and will continue to retain the King as nominal head of the government, the office of President in Germany has been combined with that of Chancellor since the death of von Hindenburg. Like Mussolini in Italy, the German dictator is independent of the Reichstag, has absolute power to determine the formation of the Cabinet and the work and legislative activities of the Reichstag, and may make laws by proclamation without action by that body. The Reichsrat, which was formerly the upper house of the German parliament, has been abolished, and the lower house (the Reichstag) apparently survives only to approve the pronouncements of the dictator.

The National Socialist Party.—Germany, like Italy, has a one-party system of government. The National Socialist (or Nazi) Party is supreme, and other political organizations are sternly suppressed. Members of

the party hold all important governmental posts, which they get by appointment from above, not by election. While elections in general have been suspended, the people have had an occasional chance to endorse the dictator's policies—being given a ballot with a large circle for voting "Ja," and a very small circle (or none at all) for voting "Nein." The National Socialist Party began to function in a small way several years before its accession to power, and now has an estimated three to four million members. Like the Italian Fascist Party, it now has youth organizations from which it will obtain members in the future. These organizations train both boys and girls, in separate groups, and are said to include about seven million members. The principal requirement for membership in the National Socialist Party appears to be a willingness to obey blindly and without question all wishes or orders of the dictator. As in other one-party countries, the Nazi Party holds periodical purges by means of which it eliminates (by death or imprisonment) any elements in the party which may have become obnoxious to the leader.

Individual Liberties.—The National Socialist Party, like the Italian Fascist Party, regards democracy as useless and an evidence of weakness on the part of a nation, and finds it desirable to suppress all rights and liberties of individuals. Freedom of assembly does not exist outside the all-powerful party. Freedom of speech has been abolished, and the press is entirely controlled by the government, printing only government-approved "news." Education is strictly controlled by the government, in order that the principles of National Socialism may be inculcated in the youth of the land. Even religion in Germany has become largely a function of the ruling party. Religious leaders have been displaced by other persons who will be amenable to the wishes of the party and will preach National Socialism, and it is reported that the Bible has been rewritten to conform to party principles. In Italy, the Catholic Church continues to function on the basis of an agreement with Mussolini, although its relations with the government are not particularly cordial.

In Germany, a man's house is not his castle if we may believe the critics of National Socialism. A citizen's house may be invaded and his personal possessions destroyed at any time by governmental representatives acting without warrant. He may be arrested without warrant, tried without jury or legal representation, and given an exceedingly severe sentence. The law is whatever the leaders say it is. It may be one thing today and quite another tomorrow. A man may be punished for an action which was not a crime or misdemeanor at the time at which it took place. He may be punished for crimes which it is presumed he will commit in the future, and for offenses which others may conceivably commit against him—this last type of punishment being called "protective arrest." He may be confined without specific charges being lodged against him. He may be arrested and punished merely for stating that a crime has been

committed—the name for this offense being “the spreading of atrocity legends.” Moreover, the German people are subjected to espionage on the part of the government to an extent which has seldom been equaled. Such are the accounts of the status of the individual under National Socialism, as reported by persons who have escaped from the country.

The Suppression of Opposition.—The National Socialist Party has emulated the Fascist Party of Italy in conducting a campaign of violence and terrorism against its opponents. In addition to those who have been killed or maimed, many thousands have been thrown into prison, or into concentration camps similar to the camps maintained for prisoners in time of war. In Italy, the intent of the government has been to subdue opposition elements, but to retain them in the population as useful members of society. In Germany the intent has been to exterminate the trouble-makers whenever possible.

Another difference suggests itself. In Italy, it was felt that opposition must be suppressed for the good of the state. In Germany, however, the good of the state is synonymous with the good of the race. According to the party program, none but members of the nation may be citizens of the state, and none but those of German (or Aryan) blood may be members of the nation. No Jew, therefore, may be a member of the nation. Much of the program of Nazi persecution and terrorism has, therefore, been directed against the Jews. The Germans are said to be psychologically powerless to admit that the loss of the first World War and the unfortunate economic conditions which followed were due to any faults of their own. They hold that the World War was lost because of the treachery and duplicity of the Jews at home, and that the Jews were responsible, also, for the unfavorable economic conditions of the post-war years. Moreover, economic recovery and prosperity are said by the proponents of anti-Semitism to wait upon the elimination of the Jews from the population.

According to Jewish refugees from Germany, it is impossible to describe briefly the treatment to which the Jews have been subjected in Germany under National Socialism. They have been deprived of citizenship and the right to vote. They have been cast out of the professions, such as teaching, medicine, journalism, and the law. They may not belong to labor unions, or work in retail and mercantile fields. Their property has often been confiscated, and they themselves are subjected to close espionage. The rights of their children to education are curtailed, as is also their right to make a livelihood through the use of land. They have suffered personal indignities and physical violence, and severe injury or death has been the portion of many. Some of the more fortunate have been able to flee the country, but those who remain are said to live in a constant state of terror and abject misery.

In Italy the campaign of suppression has been directed chiefly against

living persons, and especially against those in Italy at the time, but in Germany the works of famous German writers of the past and of citizens of other countries have been condemned by the National Socialists. Such works have been banned from circulation, and have been burned in monster bonfires staged for this purpose. Objectionable paintings have been removed from art galleries, and other works of art destroyed. Even the performance of musical compositions by certain composers has been forbidden. The National Socialists have decreed that the German nation or German race shall work out its own art and culture, so that they may be free from alien contamination.

The supporters of National Socialism are, of course, much incensed by the reports of persecution and violence which come out of Germany. They insist that these reports are no more true than were those of atrocities committed by Germans during the first World War, and that Germany is merely following a necessary and orderly policy of purifying the race and removing alien and discordant elements for the good of the nation. However, it would seem that these recent reports have appeared under circumstances much different from those of the war-time propaganda. It also appears that the program of persecution is still going on. How else shall we explain the disappearance of numbers of Germans who vanish completely, leaving no trace, the large number of "suicides," the high mortality due to pneumonia and other "natural causes" in jails and concentration camps, and the number of persons whose exit from this life is described as resulting from having been "shot while trying to escape"?

The Individual and the State.—The German and Italian systems are alike in other respects. Hitler, like Mussolini, derived much of his original support from capitalists, industrialists, and landowners, while workers were slow to join the movement. It is uncertain whether the original supporting classes have derived the benefits which they expected. In both Germany and Italy, the individual is subordinated to the strong central government not for his own good, but rather for the good of the state—or, in the case of Germany, for the good of the race. Finally, the fascist theory of the state is reflected in the economic policies which are followed in Germany, for most of these policies are aimed at promoting the power and prestige of the nation, rather than providing for the economic welfare of individual citizens.

ECONOMIC POLICIES OF NATIONAL SOCIALISM

The Controlled Economy.—The leaders of National Socialism have frequently stated that they do not intend to set up an economic system like that of Russia, in which the state owns and operates the basic means of production and individual initiative is weakened if not destroyed. On the other hand, it is certain that, in Germany, the power of government

and of the dictator to interfere with and control economic activity is virtually unlimited and extends to all branches of economic activity. The German leaders say, however, that the system is not intended to be permanently even a governmentally controlled system. The government does not propose to direct industry and trade in the long run, but intends merely to "open up the way" for private industry and trade. The influence of the government has been so extensive and pronounced thus far only because the German economy has been going through a period of emergency and reorganization. The validity of these assertions remains to be established. For the present, Germany is a state in which economic activity is completely *controlled* by the government, even though the ownership of most land and capital is left in private hands, productive units are largely privately operated, and comprehensive economic planning has not been adopted.

The German Estates.—The agencies through which economic control is achieved in Germany are quite similar to those of fascist Italy. The Italian groups of "corporations" in agriculture, manufacturing, and service find their counterparts in the German "estates" of industry and trade, agriculture, handicrafts, and transportation. Considerations of space prevent us from analyzing all of these estates, and we shall describe only one—the estate of industry and trade. All employers in these two general fields are required to belong to the estate, which is organized both functionally and geographically. Functionally, the estate is divided into six general classes of business (*Reichgruppen*): industry, handicrafts, trade, banking, insurance, and power. The industrial group is further subdivided into seven *Hauptgruppen*, each of which includes several related industries. For example, one of these *Hauptgruppen* includes mining, iron production, non-ferrous metals, and foundries, and a second is made up of foodstuffs, brewing, malting, sugar manufacturing, and alcohol distilling. The *Hauptgruppen* are subdivided into the individual industrial groups (*Wirtschaftgruppen*). All the other *Reichgruppen*, save handicrafts, are divided directly into *Wirtschaftgruppen*. The handicrafts group is made up of some 50 Reich Guild Associations.¹⁵

From a geographical point of view, Germany is divided into 14 districts for the administration of the affairs of the estate of industry and trade. In each district, an Industrial Board is set up to represent and supervise all economic interests. These Boards make recommendations which are carried out through Chambers of Commerce to which all business men must belong. All Chambers of Commerce are combined in a National Association of Chambers of Commerce and Industry. At the head of both the functional and geographical organizations is the Reich Economic Chamber, which is supposed to help the Minister of Economics carry out the economic policies of National Socialism.¹⁵ The com-

¹⁵ These organizational details are from E. R. Sikes, *Contemporary Economic Systems*, pp. 470, 471.

plicated estate of industry and trade is made to work by rigidly following the leadership principle, which is described below.

The Labor Front.—Germany under National Socialism does not have separate organizations of employers and employees comparable to the Italian syndicates and federations, but the control of labor relations by the government is as strong in Germany as in Italy. When National Socialism came into power, the labor unions, in the ordinary sense of the term, were suppressed, and the German Labor Front was created. This organization is a totalitarian body of all German citizens who take part in the country's industrial processes, and includes ordinary workers, salaried employees, and employers. Hitler is the nominal leader of the Labor Front, and the actual leader is appointed directly by him. The Labor Front is organized along party lines into 33 regions, 84 districts, and 14,744 local groups.¹⁶ Thus, it would seem to be a gigantic "company union." The Labor Front assists in settling labor disputes; attempts to bring about understanding and solidarity between workers and employers, and to minimize class distinctions; administers the insurance funds, building and loan associations, and banks of the former trade unions; operates the "Strength through Joy" movement; and in general promotes the cultural, social, and recreational welfare of the workers. It does not deal with wages, hours, and working conditions.

Labor Relations.—Really important matters in the field of labor relations are handled by a different agency, for the German labor law gives the individual employer a large measure of control over the workers in his plant. According to the official German news bureau, "The basis of the new social system is the factory. The Leader is the employer. He decides for the Following (employees) in all questions concerning the management of the plant. . . . The Following shall render faithful service to the Leader in all things related to the conduct of the undertaking. . . . This law revokes all previous laws of basic significance relating to shop councils, wage agreements, arbitration, strikes and lockouts, and similar questions." Thus, unless he is interfered with from above, the employer controls labor relations in his enterprise.

Since 1933, several thousand labor regulations have been set up in Germany. These are of two main types. First are the *establishment regulations*, or shop rules, covering such matters as wage rates, daily working hours, time and conditions of wage payment, basis of wage calculation, fines, dismissals without notice, and disposition of forfeited wages. These regulations are made by the Leader (employer) and cover a single plant or establishment. Second, there are *labor regulations*, covering hours, wages, vacations, dismissals, and many other labor conditions, which may apply to a group of plants, a whole industry, or several industries in one district or several districts. These regulations are issued by the Labor Trustees. There is one Labor Trustee in each of the 14 districts

¹⁶ *Ibid.*, p. 482.

into which Germany is divided for the purposes of the estate of industry and trade. The Trustees are expected to maintain industrial peace, oversee the appointment of advisory shop councils of workers, approve or remove members of these councils, approve or disapprove the establishment of regulations and supervise their administration, and issue labor regulations.¹⁷ The regulations of the Labor Trustees supersede those of the individual employers whenever the two cover similar points.

The supporters of National Socialism contend that the employer's domination over labor is not so complete as might be supposed from the above description, despite the fact that the use of strikes, boycotts, and other labor weapons is forbidden, for the law forbids the employer to misuse his powers or exploit his employees. The Labor Trustees and the so-called Courts of Social Honor are authorized to bring offending employers to justice. If a worker feels that his employer has been mistreating him, and fails to get satisfaction through the shop council, he may appeal to the Labor Trustee of his district. If the latter thinks the case worth pursuing, he proposes proceedings before the Court of Social Honor. Such courts may punish employers severely for malicious exploitation of labor, for willful insults to social honor, and for non-compliance with written ordinances of Labor Trustees. Malicious exploitation of labor includes unlawful overtime work, paying wages below the prevailing wage scales, undue speeding up of labor, providing unsanitary working conditions, and the denial of vacation rights. Insults to social honor include such matters as arbitrary dismissal and the use of insulting language. It is claimed that cases which come before the Courts of Social Honor are decided promptly and with justice to the workers.

On the other hand, opponents of the present régime charge that the Labor Trustees and Courts of Social Honor are mere makeshifts designed to conceal the domination of workers by employers. They say that Labor Trustees really work hand in glove with the employers, and are disposed to protect the employers' interests at all costs. Each Court of Social Honor consists of a judge, an employer, and one member of a shop council. Such a court is not likely to be biased in favor of labor. Most cases are brought to court by *workers*, because employers can usually have their way without resort to the courts. Most cases are decided in favor of the workers, because workers are unlikely to appeal to the courts unless their cases are so strong that even a biased court would decide in their favor. The Courts of Social Honor may punish workers for "bringing unfounded complaints" against employers, for "maliciously inciting other workers to discontent," or for disclosing confidential information about the enterprise.

However, the new system is not altogether satisfactory even to the employers themselves, despite the great power they exercise. They are

¹⁷ *Monthly Labor Review*, January, 1938, pp. 94-97.

restricted in many matters by regulations from above, must give their workers vacations, must pay wages for time spent by workers at Nazi rallies or in other activities required by the government. To be sure, labor has no legal right to strike, but unsanctioned strikes have sometimes occurred, and there has been considerable soldiering on the job in German industry. Because of their fear of a new undercover revolutionary movement among workers, employers have sometimes maintained factory police who are prepared at all times to handle workers' uprisings. If workers do not obey their employers, the police may be called in, but it is believed by some persons that many employers would prefer the old union organizations, with all their strikes, to the new situation.

Wages and Employment.—While the German workers seem virtually powerless in labor relations, official Nazi statistics indicate that they have not fared so badly since 1933. When the National Socialists came into power, there were some six or seven million persons unemployed in Germany. The National Socialist government immediately began an attack on the unemployment problem. One of the measures adopted was to shift people to the farms where there was a shortage of labor. The lack of farm workers was attributed to the continued growth of intensive farming, and to the tendency of farm workers to leave the country and obtain more profitable work in the cities. It was also discovered that the age ratios in some industries were not in line with the political-social needs of the country. The revival of trade had contributed largely to the benefit of the younger rather than the older workers, and the government used its power to aid these older laborers. A plan was set up for transferring workers from one area to another. Employers were required to secure permits from the government when they wished to employ workers under 25 years of age, and a governmental bonus was granted to employers who hired additional workers of 40 years or over.

Governmental labor exchanges were set up to assist in securing re-employment for labor. It was intended that, through these exchanges, vacancies occurring in industry would be filled at once, without slowing down the rate of production of any enterprise. Moreover, these exchanges were expected to fill vacancies with workers whose abilities and training suited them for the positions in question. To gain these ends, it was held that the placement of labor had to be strictly controlled by the government in the interest of the national welfare, and that the restrictions placed upon the free choice of occupations by workers would have to continue even after the immediate problem of unemployment was solved.

In addition to these measures, a great public works program was carried out; loans, subsidies, and tax remissions were granted to industries; the withdrawal of women from industrial employment was encouraged; pressure was brought to bear on private employers; and "substitute em-

ployment" in labor camps at low wages was provided for many workers. Following 1935, the rapidly expanding armaments program, the drive for national economic self-sufficiency, and the demands for goods consumed in actual warfare not only created employment for all, but led to a serious labor shortage.

Hourly wages in Germany fell sharply from 1929 to 1933, and in 1934 they were stabilized at the low levels then prevailing. It seems that they have not been raised since that time. However, because of increased employment, longer working days, and other factors, total wages in the economy rose by some 6 billion marks from 1933 to 1937. Official statistics indicate that real wages were somewhat higher in 1938 than in 1932. However, since much of the increase in national income in this period consisted of armaments and facilities for producing substitute goods, it is difficult to believe that real wages could have risen greatly.

International Trade and Foreign Exchange.—Within the framework of the estates and the agencies for handling labor relations, the government controls economic activity through restrictions on international trade, on the use of foreign exchange, on the use of raw materials, on production directly, on prices and wages, and on many other phases of economic life. Restrictions of the first three types arose in part out of Germany's past difficulties in trade and exchange, and in part from the desire for economic self-sufficiency. After the first World War, Germany, deprived of her colonies and some of her industries and former domestic sources of raw materials, was forced to depend upon other countries for much foodstuff and raw materials. As we saw in an earlier chapter, she was able, for several years, to pay for these goods and for reparations only by borrowing heavily in other countries. In the post-1929 depression, these sources of new credit dried up, and Germany was no longer able to make the foreign payments expected of her. This situation eventually resulted in Germany's refusal to make payments on account of principal and interest to creditors in other countries. The Germans did not view this action as repudiation, however, for German debtors were forced to continue to make payments on account of interest and principal in terms of marks. These payments were made to German financial institutions for the benefit of foreign creditors, but the funds could not be transferred to other countries. They might be used to pay traveling expenses in Germany, for new investments or reinvestment in Germany, and for meeting various kinds of obligations in Germany. They could not be sent abroad because Germany was unable to acquire necessary foreign exchange balances abroad from which payments could be made in foreign countries. There is little doubt about the genuineness of the Germany financial difficulties, for, in addition to making normal payments abroad for imports and on account of principal and interest, she would have been

compelled to make large payments to foreign creditors who were desirous of recalling their investments in Germany through fear of the present régime. However, her action amounts to repudiation of her obligations, from the point of view of many foreign creditors.

As a result of this situation, the German government has greatly restricted international trade and the use of foreign exchange. It has limited imports to goods that were urgently needed, and for which payments could be made out of foreign funds acquired through German exports. That is, the general rule has been not to import unless and until it was definitely known where and when foreign sales could be made to pay for the imports. Permits are required in order to import goods or use foreign exchange, and exporters must sell their foreign exchange to the government for marks. Some imports have been paid for with "blocked marks" (which can be spent only in Germany), and other goods have been secured on a barter basis. Marks of different values have been introduced for the purpose of obtaining trade advantages. The net result has been endless complexity and confusion. Since 1934, foreign exchange control has operated through 25 Control Boards, each responsible for different types of imported goods. The Boards decide the kinds and quantities of goods to be purchased and the countries to be favored with orders, and assign the necessary foreign exchange certificates or permits. A single bank is said to have maintained a staff of 500 officials for dealing with foreign exchange transactions and regulations. These regulations are strict, and heavy punishments, including even the death penalty, are provided for their violation.

Raw Material Controls.—In spite of all efforts to obtain an adequate supply of raw materials, German industries have suffered from an acute shortage of raw materials, and the shortage has sometimes held up work for weeks or even months. At one time it was reported that shipyards could obtain steel plates only after waiting eight months from the date of order. Another story tells of automobile manufacturers who ordered tires in early June and received them in mid-November. In general, manufacturers have been able to secure limited quantities of needed raw materials only by application, supported by data on past consumption and present stocks, and accompanied by proof of orders in hand for the finished products. In some industries, the establishment of new firms requiring the use of important and scarce raw materials has been forbidden unless permission was specifically granted by governmental authorities.

The Control of Prices.—The German government has complete control over prices. Following earlier experiments, a decree of November 26, 1936, required the stabilization and maintenance of all prices of commodities and services at the levels prevailing on October 18, 1936. A price

change requires the permission of the Price Commissioner, who may also change prices on his own initiative. According to official statistics, prices have been kept very stable. From 1933 to the date of the 1936 decree, both wholesale prices and cost of living rose moderately, but, from early 1937 to the end of 1938, wholesale prices rose by less than one per cent.¹⁸ German official reports indicate that prices have maintained their stability even under actual war conditions.

Investment Credit.—Investment credit is also controlled by the Nazi government. In 1938, new issues of securities totaled 8673 million marks. Of this total, 7744 millions were securities of the German government.¹⁹ The funds raised by the government are used for armaments, for the production of substitute goods, and for the encouragement of essential industries. Even the relatively few securities (stocks and bonds) issued by private industries must be used to raise funds for projects which are considered necessary by those who direct the self-sufficiency program.

The Self-sufficiency Program.—The German self-sufficiency program is even more comprehensive and far-reaching than that of fascist Italy. Under the Four-Year Plan, German agriculture was expected to increase the output of foods and raw materials already being produced in Germany but in insufficient quantities. Farmers were asked to double the number of sheep raised for wool, and to double also the quantity of land used for raising fibrous and oil-bearing plants. As in Italy, efforts have been made in Germany to increase the supply of farming land by draining swamps and reclaiming meadowland. The government has also encouraged the movement of population back to the soil, where families can at least produce their own food. In developing substitutes for scarce materials, attempts have been made to have concrete serve for steel in building construction, plastics for steel in manufacturing, glass for metal in containers, and alcohol for gasoline as motor fuel. Aluminum has been substituted for tin, zinc for brass and bronze, and copper for lead.

In the field of artificial substitutes, textiles made from "cell wool" (developed from both wood fiber and skimmed milk) have partly supplanted wool and cotton materials. Synthetic rubber and synthetic gasoline are also being produced in substantial quantities. Fish-skins are made into imitation leather; and potato peelings into linoleum and corks. An "excellent" butter is made from coal tar. It was discovered that 32 pounds of cheap fish would yield one pound of extract which is said to equal 160 hens' eggs in food value. The German authorities claim to save 400 million eggs a year through the use of these "Viking eggs."²¹

¹⁸ *New York Times*, July 10, 1939.

¹⁹ G. Reimann, *The Vampire Economy*, New York, The Vanguard Press, 1939, pp. 165-167.

²⁰ P. T. Ellsworth, *International Economics*, New York, The Macmillan Company, 1938, p. 506.

The Effects of Self-sufficiency.—The economic consequences of this self-sufficiency program are not wholly satisfactory. Since farmers now carry agricultural production beyond the point at which, as private enterprisers, they would normally stop producing, they get into the field of high costs, with the result that prices are usually high and individual consumption is restricted. In general, substitute products are less satisfactory than the goods they replace. If, for example, better buildings could be constructed by using more concrete and less steel, it is reasonable to suppose that builders would have realized this fact, and acted upon it, long before the adoption of the self-sufficiency plan.

There is abundant evidence that many of the *ersatz* products are mere makeshifts, and that they have not come into popular favor. In the first place, these substitutes are usually costly. Synthetic gasoline costs $3\frac{1}{2}$ times as much as imported gasoline would cost, synthetic rubber about 6 times as much as natural rubber, and the lowest priced cell wool textiles 30 to 40 per cent more than natural textiles. Second, these substitutes are often of poor quality—clothing made of cell wool is stiff, heavy, and disposed to retain moisture, and synthetic gasoline is too poor in quality for use in aviation, according to some experts. Finally, the manufacture of substitutes gives rise to fresh problems elsewhere in the economy. If textiles are made of milk or wood, the result may be a shortage of these two essential goods. The manufacture of synthetic rubber requires more machinery than the manufacture of natural rubber. Funds must be found for financing the productive facilities required in producing the synthetic substitutes; and these funds are often taken from established industries, with the result that the plant and equipment of these older industries are allowed to run down, and their products become higher in price, or poorer in quality, or both. A policy of self-sufficiency may be necessary in time of war, but it cannot be justified on strictly economic grounds.

Public Finance.—Germany's self-sufficiency and rearmament programs have had a striking effect on the government's financial position. Governmental expenditures increased from 9.7 billion marks in 1933-34 to 25.0 billions in 1937-38. Taxation in the same period of time increased from 6.8 to 14.0 billion marks per year, and governmental borrowing increased from 2.1 to 9.3 billion marks. The national debt, which was wiped out during the post-war inflation, rose from 9.5 to 38 billion marks in the years 1933 to 1937. We see, then, that public expenditures almost tripled, and taxation more than doubled, in a period during which the national income was increasing by about 50 per cent.²¹ In 1941, with a national income of about 100 billion marks, the German government was spending at the rate of about 80 billion marks a year. Receipts from taxation amounted to only 27.2 billion marks in the fiscal year 1941, and the na-

²¹ *Living Age*, April, 1938, pp. 110-116.

tional debt on June 30, 1941, was more than 101 billion marks, or about ten times as great as in 1933.²²

The Population Policy.—Despite its attempt to bring about economic self-sufficiency for Germany, its early difficulties in finding useful work for its labor supply, the existing population pressure, and the alleged need for colonies, National Socialism, like fascism in Italy, has followed a policy of encouraging the growth of population. This policy must be interpreted, therefore, as one which is pursued for military purposes. Governmental loans have been granted to young married couples, the cost of education and other expenses of rearing children have been reduced, and the income tax laws have been amended in favor of taxpayers with large families. Single-payment bonuses have been offered to the parents of large families, and in July, 1936, it was announced that a supplementary bonus of 10 marks a month would be paid to parents for their fifth child, and yet another for every additional child after the fifth. In Germany, as in Italy, in spite of all forms of governmental encouragement, the birth rate shows little inclination to rise. From 1934 to 1938, the excess of births over deaths remained stationary at 7 per thousand of population, as compared with 12.4 per thousand in 1913.²³

The Results of National Socialism.—It is difficult to make a satisfactory evaluation of the accomplishments of National Socialism, for the party has been in power for only a relatively short time. Moreover, its economic policies have been in effect during a period of time in which economic recovery has been taking place all over the world. Again, since official statistics in Germany are controlled by the party, there is some question of their reliability. The statistics on economic progress under National Socialism are imposing. They indicate, from 1933 through 1939, the conquest of unemployment, with an increase in employment from 11,470,000 to 21,840,000.²⁴ The industrial production index rose from 54 in 1932 to 126.8 in 1938 (1928 = 100). Germany's share in world industrial production increased from 8.4 per cent in 1932 to 13 per cent in 1938, and her national income increased from 42 billion marks in 1932 to 76 billions in 1938²⁵ (over 100 billions in 1940 and in 1941).

However, as we noted previously, the gains in employment, production, and national income took place without a corresponding increase in goods available for consumption, and, indeed, with an actual decline in standards of living. It follows that these statistics can be interpreted fairly only in the light of the nature and content of the Nazi policies. It is necessary to recognize that in Germany, as in Italy, the interests of individuals are regarded as unimportant as compared with those of the

²² *Foreign Commerce Weekly*, May 24, 1941, pp. 334, 335, and September 20, 1941, p. 15.

²³ E. R. Sikes, *Contemporary Economic Systems*, p. 526.

²⁴ *Ibid.*, p. 488.

²⁵ *Ibid.*, p. 523.

nation or race. The policies of National Socialism seem to be directed definitely toward enhancing the power and prestige of the nation or race, rather than toward producing a more abundant economic life for the citizens of Germany. National Socialism does not appear to be a system under which the individual could ever have achieved a large measure of economic welfare, even if Germany were able to establish a "New Order" in Europe and hold a permanent position as a dominant world power. But the possibility of Nazi control of Europe is steadily growing dimmer. By challenging the military and economic might of both the British Empire and the United States, Germany appears to have got herself into a desperate situation which must inevitably result in the destruction not only of her armed might but also of National Socialism as a political and economic system.

1. Why is fascism often confused with socialism and communism? Explain.
2. In what ways has the organization of the Italian government been changed under fascism?
3. "Italy, under fascism, has a one-party system of government." What is meant by this statement?
4. What is the status of individual rights and liberties under Italian fascism? Explain.
5. Explain the fascist theory of the state.
6. Did fascist Italy originally set out to operate a system of national economic planning? Explain.
7. What differences have there been, as between Italy and Russia, in the original sources of support for the party now dominant, and in the reasons for subordinating the interests of individuals to those of the state?
8. Has the Italian economy, like the Russian, been immune to business depressions and unemployment? Why?
9. Explain the nature of the Italian "corporations."
10. How do the corporations serve as instruments of governmental economic control?
11. How are workers and employers organized for dealing with each other under the fascist system?
12. How are labor questions settled under the fascist system? Explain.
13. How would you evaluate the results of the fascist labor policies? Explain.
14. Does fascist economic policy include price controls? Explain.
15. Why has Italy adopted a policy of trying to achieve economic self-sufficiency, and what are the various phases of the policy?
16. How does this policy affect the economic welfare of the individual citizens? Explain.
17. Comment on the reasons for, and the nature and results of, the Italian population policy.
18. How has the financial situation of the Italian government changed under fascism? Why?
19. "The Italian fascist system seems to be of little use either for war or for peace." Explain.
20. How does the governmental organization in Germany under National Socialism compare with that of Italy under fascism? Explain.

21. Are individual rights and liberties well protected in Germany at the present time? Explain.
22. What differences may be noted, between Italy and Germany, in the suppression of opposition to the Fascist and National Socialist Parties? Explain.
23. How do Italy and Germany compare with respect to the nature and extent of governmental control over economic activities?
24. Compare the German "estates" with the Italian "corporations."
25. Contrast the German and Italian systems of handling labor relations.
26. What have been the net results of the National Socialist labor policies?
27. How can it be argued that German workers as a whole have not fared badly under National Socialism?
28. Describe the governmental controls over international trade and foreign exchange in Germany under National Socialism.
29. How are German enterprisers controlled with respect to production and the use of raw materials?
30. Describe the National Socialist methods of controlling prices and the use of investment credit.
31. Show that the National Socialist program for economic self-sufficiency is essentially similar to the fascist program in Italy.
32. Compare the financial positions of the German and Italian governments.
33. "The National Socialist program for population increase uses the same devices and has the same indefinite results as the fascist program in Italy." Explain.
34. What is your final estimate of the results of National Socialism in Germany?

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APPENDIX

THE AMERICAN ECONOMY IN WARTIME

(The appendix, because it is revised frequently, is not included in the index.)

ECONOMIC life consists of making goods to satisfy human wants. This is quite as true in wartime as in time of peace. When threatened by military aggression, the people of a nation, if they value their sovereignty, choose tanks, planes, and guns in place of the luxuries and comforts of ordinary times. These engines of destruction become, for the duration of the war, the means of satisfying human wants, and the nation directs its economic life chiefly toward the production of these urgently needed goods or almost surely goes down in defeat. This is peculiarly true of present-day warfare, which can be waged successfully only if manpower is backed up by enormous quantities of heavy equipment. According to one military expert, "There must be about nineteen men behind every man behind a gun to keep the modern war machine going."¹ Some of the nineteen are on the field of battle, maintaining supply routes, communication lines, and repair service, but many are on farms or in mines, mills, and factories which may be thousands of miles from the scene of actual conflict. We shall undertake, in the following pages, to indicate some of the important changes that the second World War has made in American economic life.

These changes do not date from the Japanese attack upon Pearl Harbor and our formal entry into the war, but rather from the declaration of war against Germany by Great Britain and France in September, 1939. The military unpreparedness of these two nations, and the necessity of securing war supplies with all possible speed, led them to order large quantities of such goods from the United States and caused some American business concerns to shift from peace to war production. The passage of the Lease-Lend Act in March, 1941, and several huge appropriations for American national defense still further stimulated the output of war goods. Finally, our own declaration of war against Japan, Germany, and Italy in December, 1941, committed us definitely and irrevocably to the maximum production of war equipment of all kinds, not only for our own use but for the use of our allies as well.

¹ Hanson W. Baldwin, in *New York Times*, December 30, 1941.

AMERICAN PRODUCTION IN WARTIME

Permanent preparation for war is a characteristic of the fascist states. This characteristic is quite in keeping with fascist ideology, for fascism insists upon the necessity and desirability of war, and glories in achievement through force of arms.² Indeed, it is not too much to say that the goal of fascism is national supremacy, won and maintained by military power; and the attainment of this goal necessitates the development of a great war machine. Democratic nations, though seldom "too proud to fight" if sufficiently provoked, are ordinarily more interested in pursuing the arts of peace than those of war. Their goal is more likely to be high standards of living gained through economic progress than national glory won by military threat or actual conquest.

Military Handicaps of Democratic Countries.—On this account, democratic nations are at a disadvantage when attacked by fascist powers. Their armies are usually smaller or less well trained than the armies of their antagonists; and the equipment available for their use is likely to be inferior, in both quality and quantity, to that of the fascist armies. What is true of the army is equally true of the naval and air forces of the democratic countries. Not because they are "soft" and decadent, but because they ordinarily emphasize the production of commodities and services which contribute to "the good life," the people of the democracies commonly lose the early battles of a war that is forced upon them by fascist aggressors. Sometimes, of course, this initial handicap proves fatal and the poorly prepared country falls, as France fell in 1940. But if a peace-loving and economically strong country can withstand the early attacks of the enemy, it may be able to marshal its productive agencies in a war effort which will enable it to win out in the end—for, other things being equal, it is likely to be able eventually to outstrip the militaristic nation on the "economic front" where the outcome of modern warfare is often determined.

Warfare and Economic Goods.—Writers on economic theory often urge their readers to distinguish carefully between "goods phenomena" and "money phenomena." Their purpose is to stress the point that the economic process deals primarily with economic goods, and that these goods are produced by land, labor, and capital. This basic fact is made especially clear in wartime. When a nation is at war, the strength of its economic front—and therefore, to a considerable extent, the outcome of the war—depends upon the quantity and quality of the agents of production it can muster into its service. The problem of "financing the war"

² The term "fascist state" may properly be applied to Italy, Germany, and Japan. In all of these countries, the glorification of the state and its militant leaders, rather than the welfare of the citizenry, is an outstanding characteristic.

is one of relative unimportance. It was once freely predicted that Germany, Italy, and Japan could not possibly wage a long war, because the enormous cost of present-day warfare would bankrupt these countries in a few months, or in a few years at most! But we now know that so long as men are available for fighting, and so long as land, labor, and capital can be had for producing the necessary fighting equipment, the question of money fades into the background and the war goes on. The reason is that wars are fought with men and economic goods, and not with money.

The prosecution of a war increases enormously the demand for economic goods, and much of this demand is for goods that are not produced extensively, if indeed they are produced at all, in time of peace. In the case of the United States, the goods needed for war purposes might be secured (1) by increasing total production; (2) by diverting land, labor, and capital from *ordinary* to *war* production; and (3) by "living on principal," in the sense of failing to repair or replace some kinds of capital as they wear out. It is reasonable to suppose that we are using all of these measures to increase the current output of urgently needed goods, for all three would seem to be essential to an "all-out" war effort, in the absence of which we could not hope to attain the maximum production of war supplies. To these three methods of obtaining necessary goods may be added, for our allies in the United Nations, the loan (or gift) of supplies under the Lease-Lend Act; and, for the Axis Powers, the confiscation of the resources of countries which they have subdued and occupied.

Increases in the Volume of Production.—The British and French appeals for war supplies, and our own determination to arm for defense, came at a time when the United States was still feeling the effects of the post-1929 depression. This sudden demand for large quantities of goods found us, therefore, with a good deal of unused industrial capacity in many branches of production. For example, only 72.7 per cent of our facilities for producing steel were in operation in September, 1939, but by June, 1942, the production of steel had been stepped up to 99.3 per cent of full capacity. Idle labor, too, was ready and anxious to go to work, and the two years from March, 1940, to March, 1942, witnessed the employment of more than five million additional workers, according to the United States Bureau of Labor Statistics. Old plants were expanded and new plants of incredible size were erected at amazing speed. The total volume of United States' production increased 51 per cent from September, 1939 (when Britain and France declared war), to March, 1941 (when the Lease-Lend Act was passed), and 91 per cent from September, 1939, to the end of May, 1942 (six months after America's entry into the war). The fact that our war expenditures totaled

more than 25 billion dollars in this period is evidence that much of this increase in total United States' production is attributable to the manufacture of war goods.

The Diversion of Productive Agents to War Needs.—It is not possible, however, to carry on an all-out war merely by increasing total production. As more and more men are trained for active combat, the demand for war supplies keeps pace, and it becomes necessary to limit the output of consumers' goods and concentrate productive agents upon making the things which will contribute directly to the successful conclusion of the war. "Shortages of material, equipment, and transportation, and the need to convert industries to a wartime basis [force] the curtailment of many kinds of civilian production."³ In wartime, the production of economic goods is governed by the law of "first things first," which means that the really important goods are those that will aid in crushing the enemy. Though not overlooking the wisdom of supplying civilians with goods which will keep them at the height of efficiency, our wartime leaders frankly and properly recognize that the armed forces have first claim upon our productive capacity. "The military forces determine the kind and volume of the supplies essential for victory. In turn, the War Production Board,⁴ manned by civilians, undertakes the task of meeting these demands, as well as that of continuing the flow of goods and services for the maintenance of civilians."⁵ The Industry Operations Division of the War Production Board handles, among other things, the conversion of productive agents from ordinary peacetime uses to the more important uses dictated by the necessities of war. An illustration of such conversion is the stoppage of automobile production in certain factories several years ago, and the employment of those plants for the manufacture of airplane motors.

The Postponed Replacement of Capital.—In times that are ordinary, it is sound business practice to see that capital is maintained, either by keeping it in constant repair or by setting aside a fund with which new equipment can be bought when the old is worn out. In wartime, however, capital is often deliberately allowed to "run down," and the productive agents which might have been used in its upkeep are employed for increasing still further the volume of much-needed goods. This procedure may be entirely warranted under the abnormal conditions of war. Office buildings, hotels, stores, factories, mills, and railroads, as well as private dwellings, can often go for years without major repairs and without suffering irreparable damage. Under government control, the railroads of the United States continued to transport passengers and freight

³ *Survey of Current Business*, April, 1942, p. 8.

⁴ Described in a later section.

⁵ National Industrial Conference Board, Inc., *America's War Effort*, May, 1942, p. 10.

requirements to be balanced against total available supplies three months ahead. He makes a detailed breakdown of critical materials used and required, inventories on hand, shipments made and unfilled orders, by class of product and by end-use destination (army, navy, farm-machinery uses, chemical-industry uses, etc.)—giving the Board a many-dimensional view of the whole of war production and its flow, item by item. He also makes a blanket dollar estimate of his maintenance and repair needs. W.P.B. analysts swiftly preference-rate each item, the Raw Materials Division . . . marks the percentage of requested material that can be granted, . . . and the results go to the proper W.P.B. industry branch heads to deal out (allocate) the materials as specified. This statistical method . . . yields dynamic statistics, a running analysis of broad United States' industrial requirements, as against the static statistics of the Bureau of the Census. If [the Production Requirements Plan] is allowed to operate functionally within its broad concept over the whole of United States' military, industrial, and civilian requirements, mandatory upon all, it can develop a completely democratic system of allocations, dealing out materials from the bottom up upon a company by company basis. . . . P.R.P. is a great national budget of materials, a uniform accounting system, to balance supply against demand.⁶

The Production Requirements Plan is primarily a method for directing limited materials in specific amounts for specific end-uses to the war economy. . . . By shifting supplies away from non-essential uses, it can be used as a direct instrument to guide conversion to more essential war products.⁷

Our Military Production Program.—A glance at the formidable list of appropriations for military production gives some idea of the heavy burden of responsibility that has been shouldered by the War Production Board. These appropriations, as of November 30, 1942, totaled 238 billion dollars; and to this enormous amount President Roosevelt proposed, in his budget message of January 11, 1943, and Congress promptly appropriated, an addition of 97 billions for war purposes in the fiscal year ending June 30, 1944. But such sums are more quickly appropriated than actually exchanged for needed war equipment. We spent only 26 billion dollars on war goods in the *fiscal* year 1942. However, in the *calendar* year 1942 we spent approximately 55 billion dollars for war purposes;⁸ our actual war expenditure in the fiscal year 1943 was 72 billion, and our estimated war expenditure for the fiscal year 1944 is 97 billion dollars.

The military requirements of the country have necessitated not only the full utilization of existing plants capable of producing war supplies and the conversion of much peacetime equipment to war uses, but also an addition to productive capacity in the form of new industrial plants. Up to March, 1942, Congress had appropriated 14.4 billion dollars for constructing industrial plants required in war production, and by that date private business concerns had spent 2.3 billions of their own money in equipping themselves to carry on war projects. The National Indus-

⁶ *Fortune*, June, 1942, pp. 100, 101.

⁷ *Ibid.*, June, 1942, p. 124.

⁸ *New York Herald Tribune*, January 3, 1943.

trial Conference Board underlines the immensity of this plant expansion (totaling 16.7 billion dollars) by comparing it with the net book value of all manufacturing plants in the United States in 1940 (amounting to 22.5 billion). The comparison shows that in less than two years there was an increase of almost 75 per cent authorized, and in large measure actually achieved, in the productive capacity of American manufacturing plants.⁹ The justification of public payment for industrial plants to be used in war production is found in the temporary nature of such production. Private enterprise can scarcely be expected to spend billions for durable productive agents which will have outlived their usefulness, and hence be rendered virtually worthless, when hostilities have ended. Both expediency and fairness suggest that new wartime plants that are of a distinctly emergency type should be built and equipped at government expense. For the government to do less would probably interfere seriously with the attainment of maximum production at the earliest possible moment.

The Flow of War Goods.—To those who are impatient for the great military successes that wait upon the full mobilization of American industrial resources, wartime production must at first seem unbearably slow. But if at the outset it is slow, the reason is that the process of making war supplies is, in some instances, very roundabout. Much groundwork must be done before the planes, tanks, and shells begin to come off the assembly line. The appropriation of funds is a mere starting point, to be followed by the erection of a suitable plant; the procurement of machinery, materials, and labor; the development of a production schedule; and attention to scores or hundreds of other matters which must be looked after before usable goods are produced. Consequently, much of our 1942 war effort was of necessity devoted to *building up productive capacity*. There had been, for example, a serious shortage of machine tools—"the machines that make the machines"; but in 1942 we turned out twice as much of this vital equipment as in 1941, and more than seven times our output in the pre-war year of 1939. Our production of steel amounted to an all-time high, with an increase of 5 per cent over 1941, and 60 per cent over 1939. Exact figures on aluminum output are a military secret, but American production in this field is known to have been at least 50 per cent more in 1942 than in 1941, and 150 per cent more than in 1940.

The details of wartime production are not, in general, made public, but President Roosevelt reported, for the calendar year 1942, the production of 48,000 planes, 56,000 tanks and self-propelled artillery pieces, more than 8 million tons of shipping, 670,000 machine guns, 10 billion rounds of small arms ammunition, and 181 million rounds of artillery ammunition. Perhaps even more significant than these specific data is the fact that, according to the War Production Board, the *rate of war*

⁹ *America's War Effort*, p. 7.

production by American industry was four times as great in December, 1942, as when we declared war on the Axis powers a year earlier. December, 1943, found us with our industrial resources so fully mobilized that we and our allies had clearly left the Axis powers far behind in the production of war equipment.

Deliveries Under the Lease-Lend Act.—On March 11, 1943, it was officially announced that commodities and services to the amount of more than 9½ billion dollars had gone from this country to our allies of the United Nations, under the provisions of the Lease-Lend Act, in the two-year period from March, 1941, to February, 1943. About four-fifths of these goods consisted of munitions, industrial supplies, and agricultural products; the other one-fifth took the form of ship repairs, transportation, and other services. A little more than 45 per cent of the total went to Great Britain, almost 20 per cent to the Soviet Union, about 15 per cent to Africa and the Middle East, a somewhat smaller portion to China, India, Australia, and New Zealand, and 5 per cent to other avowed enemies of the Axis. For the *calendar* year 1943, our total shipments under the Lease-Lend Act were estimated at 12 billion dollars. Such evidences of America's determination and ability to serve as the "arsenal of democracy" may be expected to increase steadily throughout the duration of the war.

Wartime Problems of Producers.—Wartime production necessitates many readjustments that give rise to economic problems for which satisfactory solutions are found only with difficulty and delay, and in some instances not at all. To concerns which ordinarily engage in the manufacture of war goods, war brings an immediate and enormous demand for their products; and for establishments which can readily be converted from peacetime to wartime production, the coming of war again results in large output and handsome profits. Producers of iron and steel, ships, explosives, machine tools, airplanes, textiles of various kinds, and hundreds of other commodities that play an active part in carrying on war activities have economic good fortune almost thrust upon them by the stimulating influence of war. But many concerns are hard hit by such a turn of events. The greater convenience of placing very large orders with a few big firms—instead of employing all concerns, large or small, which are able to manufacture a given kind of war product—has prevented many of our small plants from contributing directly to war production. And their inability to procure adequate supplies of steel, aluminum, copper, rubber, silk, fuel, and other necessary materials has in thousands of cases virtually put the small producers out of business. Sometimes the difficulty, for both large and small concerns, is a shortage of skilled labor, which has been drained off in large quantity into the "essential" industries by the lure of exceptionally high wages. Or the problem may be one of a specific governmental curtailment in the pro-

duction of certain types of goods, such as refrigerators, office furniture, fancy pencils and pens, private dwellings except those of very modest cost, and many other commodities.

Maladjustments such as these are doubtless inevitable when the productive facilities of a country are being concentrated upon the task of winning a war. Sudden and extensive economic changes can hardly take place, even in time of peace, without affecting adversely the economic interests of many members of society. And when changes come as quickly as they do in wartime, and alter the very nature of one-half of the economic goods a nation turns out, they are bound to disrupt the plans of thousands of business concerns and the daily routine of millions of employees. In the rush of war, there is little time to seek solutions for any but the most serious problems. The result is that many of our productive maladjustments are, in general, accepted as unavoidable "for the duration," and are written off as one of the costs of modern warfare.

WARTIME LABOR PROBLEMS

In mechanized warfare, the workers who man the machinery of production are quite as necessary as the fighters who man the tanks, ships, and planes that engage in combat. Their work is less exciting, less dangerous, and better paid than service in the army, navy, and air force; but the deferred ratings given to workers in certain occupations under our Selective Service System is ample recognition of the essential part being played by industrial workers in the second World War. The basic principle of sound business management—to employ every worker in such a way that his ability will be utilized to the fullest—is equally good practice for a nation at war. Manpower is always important when there is work to be done, but it is doubly important in wartime. The failure to make full use of available human resources weakens a country's war effort, and may prove very costly by delaying the day of victory.

America's Wartime Labor Force.—Strictly accurate figures on the quantity and distribution of labor in the United States are seldom available. However, some interesting comparisons of the country's labor force as of December, 1941, 1942, and 1943 (based upon calculations of the National Industrial Conference Board and the War Manpower Commission) are given in Table A. These figures show a decline of 1,000,000 agricul-

TABLE A.—TOTAL LABOR FORCE OF THE UNITED STATES

	<i>End of 1941</i>	<i>End of 1942</i>	<i>End of 1943 (est.)</i>
Civilian industries	34.2 million	26.5 million	22.0 million
War industries	7.0 million	17.5 million	23.0 million
Agriculture	8.9 million	8.0 million	7.9 million
Armed forces	2.0 million	4.2 million	9.7 million
Unemployed	<u>2.9 million</u>	<u>2.0 million</u>	<u>1.0 million</u>
	55.0 million	58.2 million	63.6 million

tural workers in the course of two years, a decline of 1,900,000 in the number of unemployed persons, and an increase of 7,700,000 in the strength of our armed forces. Especially striking is the decrease of 12,-200,000 workers in civilian industries and the increase of 16,000,000 in the number of persons giving their time and energy to war production. It may be assumed that the movement of workers from civilian to war industries will continue to the end of the war. According to a District Director of the War Production Board, it is not unlikely that 25,000,000 persons will be engaged in war production in this country by 1944.¹⁰

We do not have satisfactory data on the number of women who have entered some phase or other of war work, but it was estimated in January, 1943, that there were then 4,000,000 American women war workers, as against the 500,000 of 1941. The War Manpower Commission predicted that the number would reach 6,000,000 by the end of 1943, when women would make up 25 to 30 per cent of the total labor force in war industries. This is, of course, only part of the story, for hundreds of thousands of women have accepted agricultural jobs and hundreds of thousands more have taken up other essential civilian work and thus released male workers for active combat service. In England, the shortage of labor impelled the government, as early as December, 1941, to draft even women for work in either the "uniformed services" or war production. By June, 1942, British women were being interviewed at the rate of 50,000 weekly by the Ministry of Labor, and in other women's services at the rate of 20,000 weekly.¹¹ Though the United States has not yet had to resort to conscription to secure the labor needed in essential industries, the growing shortage of manpower suggests that there was justification for the warning, voiced by a government official in 1942, that "the conscription of men and women to meet the demands of war on industry now looms as a definite possibility."¹²

Labor Shortage and the War Manpower Commission.—In April, 1942, President Roosevelt created the War Manpower Commission "to establish basic national policies to assure the most effective mobilization and maximum utilization of the nation's manpower in the prosecution of the war," and named Paul V. McNutt as Chairman of this Commission.

Until December 6, 1942, the Commission had no power to enforce compliance with its program, but on that date a new Presidential Order gave the Chairman almost dictatorial authority over the people of this country. It empowered the Commission to decide who should work, where, and at what task, and whether he should or should not serve in the armed

¹⁰ Glenn Gardiner, in *New York Times*, June 30, 1942. The National Industrial Conference Board announced, on August 22, 1943, that the number of persons then employed in the United States had reached 63,500,000.

¹¹ Tania Long, in *New York Times*, June 30, 1942.

¹² Glenn Gardiner, in *New York Times*, June 30, 1942.

forces. The Selective Service System was placed under the War Manpower Commission, which was given the duty of providing men for the armed forces through the System, was made responsible for training workers for vital industries, and was given other important functions to perform.

The necessity for centralization of direction in the utilization of manpower, and the substitution of compulsory for voluntary compliance with directives, arose with the growing acuteness of the labor shortage problem in many parts of the country. Among the specific causes of the faulty utilization of American labor are the following: "(1) workers changing jobs for higher pay; (2) employers failing to use workers effectively; (3) inadequate housing and transportation facilities, causing large turnover of workers; (4) employer prejudices in hiring workers; (5) labor piracy; (6) lack of comprehensive training programs to supply vitally needed types of skilled and unskilled labor; and (7) over-concentration of war contracts."¹³

The manpower problem is not confined to the production of war equipment, but is apparent in nearly every branch of economic activity. It is especially serious in agriculture, from which large numbers of men have been drawn into combat service and "essential industries." The threat of a crippling shortage of farm labor has emphasized the highly *essential* nature of agriculture in time of war—especially in a war in which we must feed not only our armed forces and civilians, but also, to a considerable extent, the people of all the United Nations.

By classifying occupations as "non-essential" or "essential" (and as "non-deferable" or "deferable" in their relation to active military service), by encouraging workers to shift from the former to the latter type of jobs, by specifying the conditions under which a worker might move from one job to another, and in other ways, the War Manpower Commission has attempted to utilize the labor force of the country for expediting the prosecution of the war. However, on December 10, 1943, the President signed a law which limited the Commission's power by taking from the Chairman the jurisdiction he had held over the Selective Service System, by giving preferential treatment to pre-Pearl Harbor fathers, by requiring reviews of occupational deferments by appeal boards sitting in registrants' places of employment, and by abolishing the Commission's list of non-deferable occupations under which registrants in specified occupations could be drafted regardless of order number or dependency status. By January, 1944, it appeared altogether likely that the manpower problem might soon require, by way of solution, the passage of a national service law which would permit the conscription of workers for essential industries in case voluntary appeals for additional workers failed to provide an adequate supply of labor.

¹³ *The Index*, Vol. 22, No. 4, p. 74 (New York, The New York Trust Company).

Labor Relations in Wartime.—Doubtless the thought that is uppermost in the minds of American employers and employees is the necessity of winning the war. There is no reason to question the patriotism of either of these groups, and it seems fair to say that enterprisers and workers alike stand ready to make whatever sacrifices may be required to bring victory to the Allies. But probably very few individuals are anxious to make greater personal sacrifices than are necessary, and fewer still are willing to deny themselves comforts while others are indulging in unwonted luxuries. Carrying on war production under conditions which approximate freedom of enterprise is almost certain to lead to confusion and misunderstanding, because some individuals seem to gain at the expense of others or of society as a whole. Increased demand without a corresponding increase in supply brings excessively large profits to certain business concerns and excessively high wages to some classes of workers. Employers are appalled at the cupidity of the relatively few workers whose bargaining position in time of war enables them to double their wages; and workers are equally astounded when they hear of occasional profits so huge that large bonuses are given to even minor executives to avoid the payment of high excess profits taxes.

War does not alter the general nature of labor's objectives. In wartime as in peacetime, workers are interested in getting high wages, short hours, and satisfactory working conditions. The second World War has brought higher hourly rates, and larger weekly incomes, in many industries. This is particularly true, of course, of shipbuilding, machine-tool manufacture, and other war industries, in which the government pays the bill for the products, and pays well to induce speedy delivery. Employers in ordinary industries have often been compelled to raise wages in order to hold their labor force. However, wage increases have not always kept pace with the cost of living in America, which rose about 20 per cent from 1940 to January, 1943. The real wages of some workers, therefore, showed a decline during this period. Hours of labor, too, increased somewhat, but usually without serious protest from the workers, since work in excess of 40 hours a week is usually paid for at the rate of time and a half, while work on Sundays and holidays draws double the basic wage rate.

The desire of workers or employers to gain advantages which were not willingly granted is indicated by the strikes that have occurred in the period of accelerated war production. Organized workers have not been slow to demand wage increases which they said were warranted by the increased cost of living and could readily be paid from the substantial profits being reaped by their employers. Some employers, on the other hand, have not hesitated to charge that the workers have been using the war situation to get higher wages, with the implication that a lack of patriotism was involved. This implication is no more applicable

to workers than to those employers who have taken advantage of the same war situation to increase their profits. Of course, neither of these groups is responsible for bringing about the conditions that make high wages and large profits possible. The truth is that both high wages and large profits arise almost inevitably out of a state of war, and this condition is certainly not chargeable to either labor or business enterprise. However, the workers' gains do not necessarily come without a struggle. Wartime competition among employers who need scarce labor may lead to voluntary grants of wage increases and other concessions, but the war-production strike record given in Table B shows that industrial

TABLE B.—STRIKES IN THE UNITED STATES, 1939-42

(Source: United States Bureau of Labor Statistics)

<i>Year</i>	<i>Number of Strikes</i>	<i>Workers Involved</i>	<i>Man-Days Idle</i>
1939	2613	1,170,962	17,812,219
1940	2508	576,988	6,700,872
1941	4288	2,362,620	23,047,556
1942	3060	707,000	4,475,000
1943 (5 months)	1455	1,024,000	2,800,000

conflict does not declare a truce in wartime. These figures may be compared with the ten-year average for 1930-39, which show in that decade an annual average of 2017 strikes, with 911,575 workers involved and 14,262,700 man-days idle. (In the first World War there was an annual average of about 3000 strikes during the seven-year war and post-war period.) It should be added that the 1942 strikes that directly affected war work numbered only 1359, with 568,312 workers involved and 2,095,294 man-days idle.

The National War Labor Board.—Idle manpower is bad enough at any time, since the failure to make full use of human resources results in a smaller national income than would be available if all labor were at work. But idle manpower in wartime may bring national disaster by limiting the quantity of war materials for the fighting forces or goods essential to the continued health and strength of the civilians.

The urgency of attaining maximum production and the increasing seriousness of strikes led to the introduction into Congress of several anti-strike bills, but this proposed legislation was rejected in the hope of finding voluntary means for settling industrial disputes and thus preventing interference with production. In March, 1941, President Roosevelt established the Defense Mediation Board, whose task was to hold hearings on industrial conflicts that failed to yield to employer-employee negotiations of the usual type. The Board functioned with moderate success, but its usefulness ended with the so-called Captive Mine Case in which, by a nine-to-two vote, the Board rejected the demand of the

United Mine Workers of America for a closed shop. The C.I.O. members of the Board promptly resigned, and a strike was called. John L. Lewis, president of the union, finally agreed to arbitrate the dispute, but only after three requests had been made by President Roosevelt and with full knowledge that the third member of this board of arbitration would be a man who favored the union demand. The board promptly voted to grant the union the closed shop.

The attack upon Pearl Harbor and the immediate declaration of war by the United States brought the strike problem to a head and emphasized the necessity of finding a solution. On December 17, 1941, President Roosevelt called a conference of representatives of labor and industry, at which it was agreed that for the duration of the war there would be no strikes or lockouts, that all labor disputes would be settled by peaceful means, and that a National War Labor Board should be established for the peaceful adjustment of such disputes. President Roosevelt created this Board, by Executive Order, on January 12, 1942, "for the purpose of adjusting and settling labor disputes which might interrupt work which contributes to the effective prosecution of the war." The Board consists of four public members, four employer members, and four labor members (two representing the A.F. of L. and two the C.I.O.).

Dr. William M. Leiserson, a noted industrial arbitrator, describes the War Labor Board as a body which will arbitrate and make final decisions. "It is also given authority to mediate and otherwise adjust labor disputes," he writes. "Under this authority it has reestablished the panel system of mediating disputes as it functioned under the Defense Mediation Board, and a large number of alternate labor and employer members and associate public members have been appointed to man these panels. The panels will no longer make recommendations to the parties, but will report their recommendations to the Board. Disputes will still be certified to the Board by the Department of Labor after its Conciliation Service has failed to settle them, but the Board may take jurisdiction of any dispute in a war industry on its own motion. In general form and function, therefore, there is no essential difference between the former Defense Mediation Board and the present War Labor Board. One was a mediation board that arbitrated; the other is an arbitration board that mediates."¹⁴

Anti-strike Legislation.—The National War Labor Board had an advantage over the Defense Mediation Board in starting out with a definite agreement by labor and industry to outlaw strikes and lockouts temporarily. Though this agreement has not wholly prevented strikes, as we have seen in Table B, the number and seriousness of work stoppages have been materially reduced. However, the fact that there were some

¹⁴ *United States News*, February 27, 1942, p. 36.

actual strikes and threats of others in important fields of production (notably in the mining of coal) led Congress to pass, on June 25, 1943, over the President's veto, the Connally-Smith Bill, which is known also as the War Labor Disputes Act. This Act relates to establishments "which may be required for the war effort or which may be useful in connection therewith." It authorizes government seizure of private plants in which production has been interrupted by strikes, provides (1) for maintaining the same working conditions as prevailed prior to governmental possession, and (2) for penalties against persons instigating or aiding any strike, slow-down, or interruption in plants taken over by the government. It also requires that thirty days' notice of a labor dispute must be given, and that after the expiration of this waiting period a secret strike ballot shall be conducted by the National Labor Relations Board for the purpose of determining whether a majority of the workers favors going on strike.

This anti-strike bill has been severely criticized by labor, by impartial students of labor problems, and by a good many business men, as being unlikely to improve the situation. It is regarded by many observers as being incapable of effective enforcement, and it is feared that it may encourage rather than discourage strike sentiment among groups of workers who are seeking relief from what, rightly or wrongly, they regard as more than their fair share of the economic burdens of the war. Work stoppages in 1943 by coal miners and steel workers, and a threatened nation-wide strike by railway employees, showed clearly that the problem of wartime strikes was far from solved. By the end of that year there were signs that, wisely or unwisely, Congress would soon pass further legislation designed to outlaw and penalize organized interruptions that might take place in essential industries.

PRICE CONTROL IN WARTIME

Rising Prices in Wartime.—In wartime, prices and the cost of living tend to rise rapidly and spectacularly. When a nation produces a huge volume of war goods of all kinds and constructs many new plants for the manufacture of such goods, while the production of goods for the civilian population also goes on after a fashion, the national income, expressed in terms of money paid out to all classes of income receivers, rises to abnormally high levels. At the same time, consumers' goods available for purchase are far too limited to use up all this money income if they continue to sell at prices which were current at the beginning of the war. Unless a way is found to reduce greatly the money incomes received by the people, price inflation becomes inevitable. Increased taxes can be used to absorb much of this surplus money income; and, in theory, they could be raised to such high levels as to leave the people only enough money to buy the available volume of consumers' goods at

stable prices. In practice, however, so thoroughgoing a system of taxes would almost inevitably produce inequity and maladjustment among the individual citizens. Ordinarily, there are economic, political, and psychological considerations which prevent any serious attempt being made to pay the entire cost of war through current taxation.

The national income of the United States in 1941 amounted to approximately 92 to 94.5 billion dollars, according to reliable estimates, while the total goods available for consumption would have amounted to 74 billions *at stable prices*. The situation was still worse by 1942, when price control was undertaken in earnest. The total national income was expected to reach 117 billion dollars, with consumers' goods and services falling to 69 billion dollars in terms of stable prices. Taxes and other deductions were counted on to reduce spendable 1942 incomes by about 31 billion dollars, leaving a spendable surplus, or "inflationary margin," of 17 billion dollars in the hands of the people.¹⁵ Additional purchases of war bonds, in so far as they were made from current income, would reduce this inflationary margin still further, but such purchases could not be depended upon to solve the problem completely.

The Effects of Rising Prices in Wartime.—During the first World War, prices in the United States rose sharply and the cost of living more than doubled. In spite of heavy taxation and bond sales, attempts at price control, and rationing which depended on voluntary cooperation, a family that spent \$100 a month for living expenses in 1914 had to spend \$140 a month by the end of 1917, \$164 by the end of 1918, and \$207 by the end of 1920 for the same amount of goods.¹⁵ The first World War cost the United States 31 billion dollars, 13.5 billion dollars of which represented inflated prices rather than ships, guns, and other war goods.¹⁵ In the present conflict, prices have again been rising rapidly. In the 31 months from September, 1939, to March, 1942, retail prices increased 25 per cent, general wholesale prices 31 per cent, prices of 28 selected basic raw materials 67 per cent, farm products 86 per cent, and living costs in general about 15 per cent.¹⁵ The increase in the cost of living amounted to 28.5 per cent for foods, 5.1 per cent for housing, 19.3 per cent for clothing, 7.9 per cent for fuel, and 6.8 per cent for sundries. Price increases in this 31-month period had already increased the prospective cost of this war by more than the *total cost* of the first World War; and it was estimated that if the price rise were permitted to continue, it would add at least 50 billion dollars to the cost of the second World War by the end of 1943.¹⁵

However, the increase in war costs is only one effect of sharply rising prices. They make it very difficult for business men and the government to draw up and carry out plans. Enterprises must know, within reason-

¹⁵ Office of Price Administration, Consumer Division, Washington, D. C., Releases of April 28 and 29, 1942.

able limits, what their costs and prices will be, if they are to plan and produce effectively. Government appropriations and revenue measures are speedily outmoded in periods of rapidly rising prices, and war contracts must be revised frequently. Rising prices cause people to buy goods which they do not need at the moment, and to purchase and hoard civilian goods or war materials, either to make a speculative profit or to avoid paying higher prices in the future. The result is interference with orderly and efficient production and a stimulus to price inflation.

Rising prices impose undeserved sacrifices on persons with fixed or limited incomes, and on members of substandard wage groups whose bargaining power is weak. Rising prices lower the fighting spirit of the people by reducing the purchasing power of their money incomes, and by eating into the value of savings accounts, insurance policies, and bonds. Moreover, there is always the danger that inflation will get wholly out of hand, and eventually reach a point at which money is virtually valueless, the government's credit destroyed, and production, distribution, and general economic processes broken down. Finally an inflationary process, even if it does not reach such disastrous levels, is almost certain to be followed by severe deflation and depression, with millions of persons unemployed, business men losing billions on inventories of raw materials and finished goods and failing by the thousands, and farmers suffering bankruptcy and often losing land which they purchased at inflated prices.

Early Attempts at Price Control.—Price rises in wartime are so serious that nations at war usually attempt to control prices directly. In the present conflict, the people and the government of the United States have been more fully conscious of this danger than in the first World War, and we began our attempts at price control even before we entered the war. In May, 1940, the Advisory Commission to the Council of National Defense was established. The Price Stabilization and Consumers' Divisions of this Commission were concerned with prices. The Consumers' Division laid down general principles upon which wholesalers and retailers were asked to base their pricing policies, and sought the voluntary cooperation of business men in bringing about price stabilization. The Price Stabilization Division set maximum ceiling prices on iron, steel, zinc and aluminum scrap, and on second-hand machine tools; made agreements with producers for price maintenance on copper and zinc; and warned producers of, and dealers in, iron and steel scrap, lumber, iridium, zinc scrap, quicksilver, nickel scrap, cadmium, and hides against excessive or rising prices. These measures lacked legal sanction and penalty for violation, so that the Price Stabilization and Consumers' Divisions had to rely upon exhortation, publicity, and possible appeals to Congress for legislation, in their efforts to secure compliance.

On April 11, 1941, President Roosevelt established the Office of Price

Administration and Civilian Supply (O.P.A.C.S.) to take over the functions of these two divisions. The new agency was to function under a Price Administrator, assisted by a Price Administration Committee. It was instructed "to prevent price spiraling, rising costs of living, profiteering, and inflation resulting from market conditions caused by the diversion of large segments of the nation's resources to the defense program, by interruptions to normal sources of supply, or by other influences growing out of the emergency, and to prevent speculative accumulation, withholding, and hoarding." The functions of the O.P.A.C.S. in connection with civilian supply need not concern us here, for these functions were transferred to the Office of Production Management in August, 1941, and the O.P.A.C.S. became the Office of Price Administration (O.P.A.).

The O.P.A. used several methods of price control. Commodity exchanges were induced to raise their margin requirements for dealing in rubber, pepper, cocoa, coffee, and other commodities, and later to suspend trading in "futures" of silk, rubber, copper, tin, and sugar. Producers of farm implements, automobiles, bread, furniture, household refrigerators, machine tools, railroad-car wheels, ammonium sulphate, and carbon black were asked not to raise their prices and to withdraw price increases which had been announced. The O.P.A. issued warnings concerning price rises for lumber, tin, and high-speed tool scrap, and entered into agreements which prevented price rises for kraft paper, crude oil, rubber tires, and waste paper. However, its most important control device was the so-called price ceilings, or maximum price regulations. The price ceilings were administrative orders of the O.P.A. which forbade the sale of designated commodities at prices above the level or levels specified in the orders. About a dozen of these price ceilings had been established by July 30, 1941, but 32 were in effect by the end of September, more than 60 by the end of 1941, and 105 by January 30, 1942. The early price ceilings dealt almost exclusively with raw materials, but some later ceilings had to do with semi-finished and finished commodities. The powers of the O.P.A. and of the Price Administrator, Leon Henderson, were presumably derived from the old War Powers Act of 1916, but it was not clear that the O.P.A. was authorized to use all the powers it undertook to exercise. No law providing for general price regulation and control by the federal government was passed prior to the entry of the United States into the second World War.

The Emergency Price Control Act.—When the United States entered the war in December, 1941, the need for price control by the federal government became more urgent, and Congress passed the Emergency Price Control Act, which was signed by the President on January 30, 1942. This Act continued the powers of price control in the hands of the O.P.A. and its Administrator, gave official sanction to the activities of the

O.P.A., and made possible the control of prices in general. Plans for general price regulation were being constructed even before the Act was passed, but it was not until April 28, 1942, that the so-called General Maximum Price Regulation was officially announced.

The General Maximum Price Regulation.—The General Maximum Price Regulation provided that (1) beginning May 18, 1942, retail prices of commodities and services, with some exceptions, must not exceed the highest levels which each individual seller charged during March, 1942; (2) beginning May 11, 1942, manufacturers' and wholesalers' prices and the prices for wholesale and industrial services must not exceed the highest March levels for each seller; (3) beginning July 1, 1942, no one could legally charge more for services sold at retail in connection with a commodity than he charged during March; (4) effective immediately, all retailers, wholesalers, manufacturers, and sellers of services must preserve existing records of sales made during March for maximum pricing purposes when the ceiling went into effect. The Regulation also provided for the immediate licensing of all retailers and wholesalers, effective as of the date on which the ceiling applied to their particular commodities or services; that is, retailers were directed to regard themselves licensed as of May 18, and wholesalers as of May 11. Official registration and licensing on a national scale were to come later.

Goods Included in the General Maximum Price Regulation.—The General Maximum Price Regulation (G.M.P.R.) applied to literally thousands of types of goods. Among the prices controlled were those of almost every processed food commodity, such as bread, cake, and other bakery products; beef, pork, and their products; sugar; fluid milk and cream sold at retail; ice cream; canned fruits, vegetables, meats, and soups; canned fish and other canned seafood; cereals; lard and shortening; coffee, tea, cocoa, salt, and spices. Also covered by the Regulation were all clothing, shoes, drygoods, and yard goods; soap in all forms; every kind of common fuel (even firewood); pipes, cigars, cigarettes, and prepared smoking and chewing tobaccos; drugs, toiletries, and sundries; furniture and furnishings; appliances and equipment; and hardware and miscellaneous agricultural supplies. Many commodities, including those which are most significant in the budgets of average low- and middle-income family groups, were specifically mentioned as "cost of living" items. Maximum prices for these articles, as permitted by the G.M.P.R., had to be publicly displayed by each retailer for the protection of his customers.

In addition to the many commodities covered by the G.M.P.R., certain commodities seemed to require special treatment and were covered by individual price schedules or ceilings issued at the same time as the general Regulation. In effect, this meant merely that 98 of the 105 schedules or ceilings which were already in effect were reissued on the

basis of the new law for price control. The commodities included bituminous coal, rolled zinc products, non-ferrous castings, fluorspar, standard newsprint paper, camelback for recapping and retreading tires, waterproof footwear, farm equipment, construction and road maintenance equipment, mixed fertilizer, machines and parts, paper, paper products, and many other things.

The G.M.P.R. covered the prices charged for all services sold at retail in connection with the installation, maintenance, preservation, repair, storage, and distribution of commodities. Thus, the rates charged by automobile repair shops, garages, tailors, laundries, dry cleaners, shoe repair shops, and other similar establishments were controlled. Prices of services not sold at retail (as, for example, the repair of machinery in a factory by an outside contractor) were also controlled.

Goods Excluded by the G.M.P.R.—Though the O.P.A. officials announced that the G.M.P.R. covered “virtually all commodities,” it seemed to outside observers that the list of exceptions and exclusions was quite long. The commodities and services not covered by the regulation fell generally into three classes.

1. Economic goods which were exempt because of the provisions of the Emergency Price Control Act either (a) because they did not fall within the Act's definition of a “commodity” (which excluded advertising, newspapers, books, magazines, motion pictures, *wages*, common carrier and public utility rates, insurance, real estate, and professional fees) or (b) because of the Act's special treatment of agricultural commodities unless they attained a price level reflecting a substantial premium over parity.

2. Commodities which did not have organized markets, and for which it would have been almost impossible to determine maximum prices on the basis of either previous sales or prices for comparable articles. Examples are highly seasonal fresh vegetables, fresh fish and game, objects of art, and collectors' items.

3. Primary raw materials (such as timber and mineral ores) whose prices were already under control by virtue of individual price ceilings previously established.

Rent Control.—Even before the issuance of the G.M.P.R., the O.P.A. had served notice on landlords to reduce rents in 21 “defense rental areas” with an aggregate population of 10 million persons. While the G.M.P.R. itself did not deal with rents, companion orders issued at the same time extended rent control to 302 additional areas in 46 states and Puerto Rico. Maximum rent ceilings were recommended for each of these areas and, if the recommendations were not carried out within sixty days, the Price Administrator could step in and impose federal controls. In most of the areas, the recommendations carried rents back to the level of March 1, 1942, thus wiping out any increases that occurred

during the spring moving and leasing period. In 64 areas, the recent rent increases were found to be exorbitant and the recommendations involved a return to the rent levels of July, 1941, April, 1941, or even January, 1941. Of the 323 defense rental areas specified, 132 contained establishments of the armed forces, 63 were primarily centers of ordnance manufacture and storage, 15 were mainly shipbuilding and ship repair centers, 8 were locations of aircraft plants, and the remaining 105 contained establishments engaged in varied war production.¹⁶

Difficulties in Determining Maximum Prices.—The G.M.P.R. did not require all sellers of commodities and services covered by the Regulation to charge the same prices. Since each individual seller could charge no more for a good than the highest price he charged in March, 1942, the price of a given commodity might vary from store to store, even though the stores were under common ownership or were located in the same neighborhood. A seller was at liberty, of course, to charge less than the maximum price for any commodity he sold. The "highest price charged" in March, 1942, ordinarily meant one of two things. First, it might mean the top price at which a good was delivered in March, 1942, in completion of a sale to a purchaser of the same class. In such a case, customary allowances, discounts, or other price differentials could not be changed, except to lower the price. Second, if there was no actual delivery of a particular commodity, the seller could establish as his maximum price the highest figure at which he had *offered* it for sale in March, 1942. Such an offering price could not be a "freak" price quoted to open bargaining, or one never intended to apply to a bona fide sale. These two provisions were expected to enable sellers to determine maximum prices for many of their commodities without great difficulty.

However, the situation became much more complicated when sellers in a later period dealt in commodities which they had not sold or offered for sale in March, 1942. For such a commodity, a seller was required to set as his maximum price the highest figure charged in March for the most nearly similar commodity. A similar commodity was defined as one that had the same use, gave the buyer fairly equivalent serviceability, and was of a type which ordinarily would be sold in the same price line. Differences in mere style or design which did not affect use, serviceability, or price line could not be taken into account. If the seller did not deal in the same or similar goods at all during March, 1942, he was required to base his maximum charges on the highest prices charged during March by his most closely competitive seller of the same class. The seller could not use the prices of a more elaborate store in a better neighborhood, but had to select a store as much like his own as possible. If the "competitive seller" did not carry exactly the same good in March,

¹⁶ Office of Price Administration, Washington, D. C., Press Release of April 28, 1942.

the seller seeking a basis for his maximum price was again required to apply the "most nearly similar commodity" standard, as described above. In this case, however, he was required to base his maximum price on the highest price charged by his competitor in March, 1942, for the most nearly similar commodity.

If the seller decided that he was unable to determine his maximum price under these provisions, he was required to select the fastest-moving comparable commodity in the same general classification, divide its maximum price by its current replacement cost, and multiply by the resultant percentage the cost of the article for which a maximum price was being sought. The result was the maximum price of the good, and this price had to be reported to the nearest O.P.A. field office within ten days. This method applied only to wholesalers and retailers. Other sellers who could not determine their maximum prices under the existing provisions were instructed to apply to the O.P.A. for alternative pricing methods. Thus, the determination of maximum prices was a complicated process in many cases, the various methods for determining such prices were at least partly conflicting, the individual seller was allowed considerable discretion in setting prices for some articles, and some of the pricing methods called upon the sellers to make use of information (information regarding prices charged by competitors, and the most nearly similar commodities which they carried) which in many instances was not readily available. The O.P.A. did not specify what sort of evidence it would accept in relation to competitors' prices and commodities, or the relative importance it would place on "closeness" of the competitors and "similarity" of the commodities.

Difficulties of Compliance.—The O.P.A. altered its organization considerably for the purpose of administering the G.M.P.R. In the Washington office a Retail Trade and Services Division was set up to iron out irregularities in price ceilings at the retail level, and to work with retailers in the administration of the Regulation. Regional offices of the O.P.A. in a number of leading cities were enlarged, and special staffs were added. State and district offices were opened to achieve decentralized administration, and local War Prices and Rationing Boards were established in individual communities. However, despite the administration and enforcement organizations that were set up, it was clear from the beginning that price control under the G.M.P.R. could not operate successfully unless it had the whole-hearted cooperation of business men, and this cooperation was difficult to obtain.

The chief reason was not that business men were opposed to price control, or that they were not "men of good will." It was rather that business men could not determine their responsibilities under price control, and did not know exactly what they had to do in order to comply with the G.M.P.R. As we have seen, the provisions for determining

maximum prices were often difficult to understand and follow, and the efforts of the O.P.A. to interpret and clarify its provisions and rulings were frequently unsuccessful. The interpretations issued by the O.P.A. would often clarify the individual cases under discussion while leaving in even greater doubt than before the methods for handling slightly different cases. The retailers of the country soon found themselves trying to operate under some 900 O.P.A. rules and 15,000 pages of O.P.A. regulations, rules, and interpretations affecting merchants, and the burden of full compliance became well-nigh intolerable.

Sellers' Hardships Under Price Control.—Before the G.M.P.R. had been in operation very long, many sellers of goods, especially at the retail level, began to complain that they were being subjected to an unbearable "squeeze." Because of the roundaboutness of the processes of production and distribution, retail prices in March, 1942, were based not on manufacturing costs and wholesale prices then current, but rather on those of an earlier date. However, the G.M.P.R. fixed manufacturers', wholesalers', and retailers' prices at March, 1942, levels. When retailers had to replace exhausted items, they were unable to make a profit by buying goods at March wholesale prices and selling at March retail prices, and found themselves at times even incurring actual losses. Still louder complaints were registered by merchants who had been selling certain articles in March at unusually low "sale" prices, or who had not by March adjusted their retail prices so as to compensate fully for earlier advances in the wholesale prices they paid for the goods. Similar problems arose at other levels of the distributive process.

Some steps were taken fairly promptly to provide for these and other difficulties. Retailers, wholesalers, and manufacturers were allowed to adjust their maximum prices upward in individual cases of hardship. Producers and sellers of some seasonal commodities who were troubled by sharply increased costs since the previous season were permitted to set maximum prices on the basis of replacement costs plus the preceding season's rate of markup. Similar concessions were made in the case of certain unstandardized articles and commodities whose specifications had undergone changes as the result of shortages of materials. In some cases, attempts were made to "roll back" the prices of wholesalers and retailers, instead of permitting advances in retail prices. In others, sellers were instructed to "hold the line" with regard to their maximum prices, while the federal government paid them direct subsidies to enable them to operate in spite of unfavorable cost-price relationships. All these devices were of some assistance to hard-pressed sellers at various levels, but at least a part of the hardships remained.

Incompleteness of Price Control.—The G.M.P.R. could not be expected to be completely successful in controlling prices in general, because it did not apply to prices in general. Wages, the price paid for labor, had

been excluded from control, and so also had the prices of basic agricultural commodities, fresh fruits and vegetables, eggs and poultry, butter and other dairy products, fresh fish and other seafood, mutton and lamb, and flour. These excluded commodities and services were important, and their uncontrolled prices continued to rise after the G.M.P.R. went into effect. The rises in uncontrolled prices were of significance not only in themselves, but because of the pressure which they brought to bear on the prices of other things. Manufacturers, wholesalers, and retailers found it difficult to keep their maximum prices unchanged in the face of rising costs of labor and agricultural raw materials. It was evident almost from the beginning that price control would have to be extended if it were to operate effectively.

Wage Control.—The so-called Anti-Inflation Act of October 2, 1942, and various administrative orders issued thereunder, constituted an attempt to deal with some of the pressing problems of price control. In particular, this Act laid the foundations for controlling wages and the prices of agricultural products, and delegated broad powers to the President to take action along the lines which it indicated. The President at once issued an Executive Order creating an Office of Economic Stabilization, headed by an Economic Stabilization Director who was to have important powers in the campaign against inflation. Late in October, 1942, the Economic Stabilization Director issued extensive regulations for the control of wages and salaries. The control of wage payments, and of salaries not in excess of \$5000 per year paid to employees who were represented by a duly recognized or certified labor organization or who were not employed in a bona fide executive, administrative, or professional capacity, was turned over to the National War Labor Board. The control of salaries of more than \$5000 per year, and of other salaries of \$30 a week or more paid to individuals employed in executive, administrative, or professional capacities, was given to the Commissioner of Internal Revenue in the Treasury Department.

Under detailed regulations laid down by the National War Labor Board and the Commissioner of Internal Revenue in December, 1942, wages and salaries of \$5000 or less per year were in general frozen at the level prevailing on September 15, 1942; and salaries higher than \$5000 per year, or lower salaries paid to individuals employed in executive, administrative, or professional capacities, were frozen at the October 3, 1942, level. According to the National War Labor Board, increases in compensation for persons whose wages or salaries came under its jurisdiction would be permitted only to correct maladjustments or inequalities, to eliminate substandards of living, to correct gross inequities, or to aid in the effective prosecution of the war. Wage increases to correct maladjustments could be made only within industries specifically designated by the Board and were limited by the "Little Steel formula,"

which provided for an adjustment of 15 per cent in the average, straight-time, hourly earnings above those of January 1, 1941, to compensate for increases in the cost of living. Increases to adjust gross inequities were permitted only when the inequities resulted from manifest injustices that arose from unusual and unreasonable differences in wage rates. Established and stabilized wage differences were to be considered normal in American industry and were not to be disturbed. Increases in pay to eliminate substandards of living were seldom to be permitted, because of a lack of general agreement on the meaning of "substandard of living." Increases in wages as an aid to the effective prosecution of the war were almost never to be allowed, because almost any wage adjustment might be defended on this ground; hence, an endless series of wage increases would result from the general use of this yardstick. The Board has ruled against making wage and salary adjustments for the purpose of influencing the distribution of manpower among industries, holding that it is not the Board's responsibility to determine who is to get the limited amount of available labor, and that a flood of wage increases would accompany the general use of wage adjustments for this purpose.

The Commissioner of Internal Revenue, in regulating the salaries under his jurisdiction, has decided that increases in salaries would be approved only when necessary to correct maladjustments or inequalities or to aid in the effective prosecution of the war. However, the Commissioner's approval is not necessary when an increase in salary rate is made in accordance with the terms of a salary agreement or salary rate-schedule which was in effect on October 3, 1942, or approved thereafter by the Commissioner, and when a salary increase is the result of (1) individual promotions or reclassifications, (2) individual merit increases within established salary rate ranges, (3) operation of an established plan of salary increases based on length of service, (4) increased productivity under incentive plans, (5) operation of a trainee system, or (6) such other reasons or circumstances as may be prescribed in rulings or regulations promulgated by the Commissioner from time to time. For both wages and salaries, the continued payment of bonuses, fees, gifts, commissions, and other forms of compensation customarily paid to employees is permitted, but such payments may be no greater in amount and rate than those which were made in the preceding year.

Extended Price Control.—The Anti-Inflation Act also provided for the control of the prices of basic agricultural commodities. It indicated that maximum prices for such products were to be established at the higher of two levels: (1) the parity prices of the commodities, and (2) the highest prices received for the commodities between January 1, 1942, and September 15, 1942. On this basis, the President ordered the Economic Stabilization Director, the Secretary of Agriculture, and the Price Administrator to freeze the prices of agricultural products in so far as it

might prove to be practicable, at the levels which prevailed on September 15, 1942. Maximum prices determined in this way exceeded parity for a number of agricultural products. Much progress has also been made in bringing the prices of other products, such as fresh fruits and vegetables, butter, eggs, poultry, and fresh fish, under control.

Revised Methods of Calculating Maximum Prices.—The difficulties of calculating maximum prices under the principles laid down by the G.M.P.R., and the hardships suffered by sellers under the operation of these principles, were recognized in the Anti-Inflation Act, and a remedy was provided in the form of new methods for calculating maximum prices. Starting with a few commodities in October, 1942, retailers and wholesalers were permitted to base their maximum prices on the replacement cost of the commodities, plus varying percentages of markup which depended on the type of establishment operated by the sellers and their annual volume of business. The application of this method was extended to more and more commodities as time went on. In December, 1942, the O.P.A. announced that individual-store price ceilings for foods and other grocery store items would be replaced by flat dollar-and-cents price ceilings in 1943, and that the same procedure would be followed for wholesalers' maximum prices. The new price ceilings at retail were to be uniform for each class of retailers in each locality, such as independents, chain stores, and super-markets. However, prices of the same items would vary from one zone to another. The maximum prices would still be computed on the basis of replacement cost plus markup, but the work of computing the maximum prices would be transferred from the sellers to the field offices of the O.P.A. Since the beginning of 1943, such flat dollar-and-cents maximum prices have been established for a number of commodities.

The Success of Price Control.—Considering the difficulties under which it has labored, the price-control mechanism has operated fairly successfully thus far. Prices have not been kept perfectly stable, but they have advanced only slowly under price control. The cost-of-living index of the United States Department of Labor stood at 116.0 (1935–1939 = 100) in May, 1942, when price control went into effect and had reached only 124.8 by June, 1943. In the same period the Department of Labor's wholesale commodity price index advanced from 98.8 (1926 = 100) to 103.8,¹⁷ which may be compared with an increase of 32 per cent in the first three years after the outbreak of the second World War. By far the greater part of the increases in wholesale prices and cost of living since May, 1942, has resulted from advances in prices which were not yet subject to control. In June and July, 1943, with almost all prices finally covered by the price-control mechanism, the cost-of-living index actually declined. On the whole, price control appears at the moment to be working very effectively.

¹⁷ *Survey of Current Business*, March, 1943, p. S 3, and September, 1943, p. S 3.

One phase of price regulation that has met with outstanding success is rent control. After the passage of the Anti-Inflation Act, rent control, which began in earnest at the time the G.M.P.R. was issued, was sharply extended. On October 11, 1942, acting under a directive from the President, the O.P.A. declared the entire nation to be a defense rental area, which meant that federal rent control could be imposed in any part of the country in which local authorities were found to be unable to control the rent situation within 60 days. Direct federal rent control had already been applied in 287 areas by October, 1942,¹⁸ and the number of such areas has since increased. The rent index, which is a part of the Department of Labor's cost-of-living index, was 109.9 in May, 1942. By July, it had declined to 108.0, and it has remained fixed at that level to this time.¹⁹ In view of the importance of rent in the cost of living of millions of families, this stabilization of rents is a noteworthy accomplishment.

Continuing Problems of Price Control.—But the continued success of price control is by no means assured. Indeed, it would be hazardous to prophesy the future effectiveness of price control in the face of sharply increasing individual incomes and a dwindling supply of consumable goods. The effectiveness of price control is closely related to the fiscal policy of the federal government. Up to the present time, federal tax revenues, while they have been increasing rapidly, have not been nearly large enough to close the gap between the income payments received by individuals and the amounts these individuals can spend on available commodities and services at stable prices, and the sale of government bonds has only partly succeeded in closing the gap.

The 1943 "Inflationary Gap."—In 1943, for example, it was estimated that income payments to individuals would total 142 billion dollars, while taxes and possible expenditures for commodities and services would absorb only 106 billion dollars, leaving an inflationary gap of 36 billions in the hands of individuals.²⁰ Sales of war bonds in the first half of the year amounted to over 6 billion dollars,²¹ but these sales, if continued at the same rate throughout the year, would use up only a little over one-third of the excess incomes of individuals. On the basis of 1942 experience, we may assume that at least 38 per cent of these excess 1943 incomes takes the form of currency and bank deposits available for spending.²² Under these conditions, the upward pressure on prices may make it very difficult to keep prices within bounds, and direct and indirect violations of price control may increase rapidly.

When the controlled prices of economic goods fail to bring about an effective equilibrium of demand and supply in the market, "black mar-

¹⁸ *Chicago Tribune*, October 12, 1942.

¹⁹ *Survey of Current Business*, March, 1943, p. S 3, and September, 1943, p. S 3.

²⁰ *Survey of Current Business*, September, 1943, p. 6.

²¹ *Ibid.*, p. S 18.

²² *Ibid.*, p. 5.

kets" are likely to spring up, in which quantities of goods whose prices are supposed to be controlled are sold surreptitiously at very high prices. While substantial penalties have been provided for the violation of price-control regulations, those regulations are very hard to enforce when sellers and consumers conspire to violate them; and black markets of alarming proportions have existed at times in the last year and a half for such articles as meats, gasoline, shotgun shells, and other items.

Subsidies in Price Stabilization.—From time to time, the O.P.A. has recognized the great pressure which is being exerted on controlled prices. In some cases, direct increases in maximum or ceiling prices have been permitted. In others, sellers have been required to hold the line with respect to maximum prices, or even to reduce these prices, and direct governmental subsidies have been paid to enable producers to continue to do business. When subsidies are used to maintain stable prices, the citizens are not injured by having to pay increasing prices for goods, but they are adversely affected (sooner or later) by having to pay higher taxes to furnish the revenue from which the government makes subsidy payments. The relative cost of rising prices and subsidy payments is a moot question at present. Some writers contend that subsidy payments are much more costly than rising prices in the long run, while others hold that such payments are in reality reasonable in view of the savings which governmental departments realize by being able to purchase tremendous volumes of goods at stable prices. On the other hand, subsidies are often condemned because they may lead to inefficiency among producers, because they may increase the already great dependence of private business and industry on the government, and because their use opens the way to political pressure and intrigue.²³

Evasion of Price Ceilings.—Despite price concessions made by the O.P.A. because of great pressure from business men, some manufacturers and sellers have taken matters into their own hands in an attempt to feather their nests under the favorable market conditions of wartime. At times, manufacturers have altered their products so that they became "new" products on which there were no established price ceilings.²⁴ While principles for the pricing of such new commodities have been laid down by the O.P.A., it is quite possible that the new ceiling prices based on replacement cost plus the usual rate of markup, which retailers receive, have given the manufacturers increased earnings. The sellers of goods have sometimes resorted to combination sales in an effort to increase their income. When some prices were controlled while others were not, a seller would sometimes refuse to sell a quantity of a price-controlled commodity unless the purchaser also took a quantity of some other

²³ Victor Abramson, "Price Freezing Under the Office of Price Administration," in *American Economic Review*, December, 1942, p. 766.

²⁴ One example has been found in a popular line of canned soups.

article, which did not come under price control, at an abnormally high price. Now that most prices are controlled, a seller may still refuse to sell a low-priced commodity on which his margin of profit is small unless the customer purchases a quantity of a higher-priced commodity on which the seller's margin of profit is larger.

Again, it has been difficult to keep manufacturers from lowering the quality of their products by using low-grade substitute materials or employing slipshod and less costly methods of manufacture. Selling an inferior product at the old price is, of course, equivalent to selling the former product at a higher price. The attitude of the O.P.A. toward changes in quality has been two-toned. When producers have complained of their inability to cover costs under ceiling prices, they have sometimes been advised to reduce their costs by eliminating frills and special features and by decreasing variety. On the other hand, where producers have without authority gone ahead and lowered quality while maintaining stable prices, they have often been upbraided by the O.P.A. for trying to evade the price regulations and have been ordered to maintain the quality of their goods. When goods are sold by the "package" rather than by definite units of weight or measure, producers may sometimes obtain concealed price increases by reducing the contents of the package without changing the quality of the product. The difficulties of enforcement under such circumstances are obvious. And, if all other methods fail, it is difficult to keep a buyer from paying only the ceiling price, and then wagering (say) \$1 or \$100 that the seller cannot jump over his own wastebasket!

Increased Costs of Living Under Stable Prices.—Incredible as it sounds, the ordinary consumer may find his cost of living going up even though prices and the cost-of-living index are entirely stable. Under ceiling prices, producers may find it more profitable to produce high-grade or luxury items whose maximum prices are high than staple items whose maximum prices are low, and may discontinue production of the low-priced lines. As low-priced goods disappear from the stores, consumers must either purchase better grades or go without. Clearly, the consumer experiences an increase in his cost of living if he asks for hamburger steak at 30 cents a pound and finds he must buy sirloin at 50 cents or go without steak, or if he tries to buy his usual grade of shoes at \$4 and finds he must take a better grade at \$6 or buy no shoes—even though the prices of all these grades of goods are quite stable. Consumers have sometimes suffered also as the result of the upgrading of goods, rather than the concentration of production on the higher-priced lines. Meat markets a few years ago carried two grades of bacon with a sizeable difference in price between them. Now the same markets have only one grade of bacon, the best, selling at the maximum ceiling price. Unless the hogs have reformed so that they no longer yield any second-grade

bacon, or the second-grade bacon that is produced is going to our armed forces or our allies, it seems probable that what used to be "second-grade bacon" now sometimes masquerades as first-grade, and thus sells at a higher price than in the past.

The Desirability of General Price Control.—Leaving now the question of the effectiveness of price control, we consider briefly the consequences that successful price control might be expected to bring. It seems obvious that it is desirable to stabilize the prices of commodities and services which play an important part in the cost of living of most people, but it is far less clear that the prices of other things should be severely controlled. The prosecution of a major war calls for rapid and extensive changes in the structure of production. More of one good must be produced speedily, while the output of another is sharply reduced. Factors of production which were recently needed here are now badly needed elsewhere, and so on. In situations such as these, fixed prices may, indeed, be successful. They provide a measure of certainty with regard to future costs, and in this way encourage business men to continue production, and discourage the withholding of goods from the market in the hope of making a speculative gain through rising prices. Moreover, when wages are frozen, needless shifts of workers from one occupation to another are reduced in number.

On the other hand, a general system of price control may have serious disadvantages in time of war. A system of frozen prices, as originally set up, would seem quite unlikely to stabilize prices and profits at desirable levels and in appropriate relationship to each other as between industries. It is even less likely that the controlled prices could be changed promptly and continuously through time so as to reflect accurately the changes that occurred in the demands of war for production, in the efficiency with which various industries could operate, and in the materials required or available for use. Hence, desirable shifts in production and in the use of the productive factors might be impeded, and some industries might be content to produce the things that could be produced profitably under controlled prices, rather than other things which, though less profitable under price control, were more essential to the war effort. Finally, the price changes a government sees fit to make might seem to manufacturers and business men quite as unpredictable as price changes that would occur under the influence of market forces only. These considerations should be construed not as arguments against price control, but rather as reasons for having selective rather than general price control.

INTERNATIONAL TRADE

Regardless of one's opinion on the restriction of international trade in peacetime, it is evident that, in time of war, a country must adjust its

foreign trade relations to the end of defeating the enemy. The second World War has brought many changes in the international trade of the United States and in the control of this trade by the federal government, though some of these changes occurred, in whole or in part, before the actual entry of the United States into the conflict.

Stock Piles of Strategic and Critical Materials.—Even before the war began, the government became concerned about our supplies of certain strategic and critical materials and took preliminary steps toward acquiring stocks of these goods. "Strategic" materials are those which are essential to national defense and must be obtained almost wholly from foreign countries. This description fits tin, rubber, silk, tungsten, quinine, nickel, mercury, manganese, and several other commodities. In the case of "critical" materials, our dependence on foreign sources of supply is somewhat less, or the materials themselves are less essential to the prosecution of war. Aluminum, asbestos, hides, and wool may be said to fall into this class. After the beginning of the war, the government placed a total of 72 raw materials under observation or control, including 17 strategic, 20 critical, and 35 other important materials.

In 1938, the Navy Department took the first step in the stock-pile program when it devoted a fund of \$3,500,000 to the purchase of certain strategic materials. The Procurement Division of the Treasury Department was assigned \$100,000,000 in June, 1939, for accumulating stock piles over a four-year period. After the war actually broke out in Europe, the Reconstruction Finance Corporation was given the power to set up special governmental corporations for accumulating stocks of various materials, and it proceeded to create the Rubber Reserve Company, the Metals Reserve Company, and the Defense Supplies Corporation for this purpose. Altogether the program was placed in the control of seven different governmental agencies. The program for accumulating stock piles of essential raw materials was completely desirable under the circumstances, though it was subject to the usual criticism of "too little and too late."

Exclusive Purchasing Agreements.—The United States also entered into agreements with Latin American countries for the purchase of all their available supplies of certain strategic and critical materials. In November, 1940, the Metals Reserve Company agreed to purchase 18,000 tons of tin from Bolivia annually for a five-year period, and later agreed to buy all available exportable surpluses of copper from the copper-producing countries of Latin America. The first overall agreement for the purchase of materials was entered into with Brazil in May, 1941. It called for the United States to take the entire exportable surplus of certain Brazilian products at stipulated prices for a period of two years. The list included bauxite, beryl ore, chromite, ferronickel, industrial diamonds, manganese, mica, quartz crystals, and zircon, and provision was

made for the addition of other articles later on. Eventually, we may get appreciable quantities of rubber, copper, iron, magnesium ore, graphite, titanium ore, hemp, and caroa fiber (to be used in place of jute) from Brazil.

Overall agreements were later concluded with Mexico, Peru, and other countries. Mexico is important as our chief source of three vital materials (antimony, graphite, and mercury) and as a minor source of tungsten, vanadium, tin, hides, and guayule rubber. One important feature of these agreements is the stipulation that exports of the specified products shall be prohibited except to the United States or other countries of the western hemisphere which have adequate systems of export control. The agreements serve to augment our supplies of the strategic materials, to assure the Latin American countries of a market for their products, and to cut off the Axis nations from supplies of these materials in the western hemisphere.

Our government, through various agencies, has also made loans to some Latin American countries to ease their foreign exchange difficulties and encourage the production of commodities which the United States is anxious to import, and it has relaxed its export controls to make possible the shipment to Latin American countries of a number of relatively scarce commodities essential to the war program. Since December 27, 1941, the government has had complete control over imports of antimony, cadmium, copper, chromium, graphite, kyanite, lead, mercury, rutile, tungsten, vanadium, zinc, and zircon. These commodities can be imported only by the Metals Reserve Company or some other government agency.

The "Freezing" of Foreign Assets.—The "freezing" of foreign assets, which is the popular name for the federal government's method of controlling foreign funds and property, began with the invasion of Denmark and Norway by Germany in April, 1940. The freezing process is based on Executive Order administered by the Federal Reserve banks and the Treasury Department, and it prohibits all transactions within the jurisdiction of the United States in which the country (or its nationals), to which the order applies, has any interest, after a stipulated date. The freezing process was extended to country after country as German conquests continued, to Germany and Italy themselves in June, 1941, and to Japan in July, 1941. The orders were originally intended to prevent Germany from using for her own purposes the funds and property owned by occupied countries in the United States, but later came to be regarded as devices for preventing any direct or indirect use of foreign funds and property in ways contrary to the interests of the United States.

Freezing orders are closely related to international trade. All exports and imports between the United States and any country whose assets

have been frozen are automatically prohibited, unless our government sees fit to issue licenses for specific transactions. This is true also of transactions between countries with frozen assets and any third country, if the transactions are to be financed by means of foreign credits held in the United States. No licenses were issued for trade with Germany, Italy, and the occupied countries even before our entry into the war, but licenses were sometimes issued for transactions with such countries as Sweden, Portugal, Spain, and Switzerland, when it was considered likely that the transactions would not inure indirectly to the benefit of the Axis nations.

The Proclaimed List.—The freezing orders as such were not applied to the Latin American countries, but something of the same effect was produced by the promulgation in July, 1941, of the Proclaimed List of Certain Blocked Nationals. This list contained the names of persons and firms believed to be nationals of or sympathizers with the Axis countries and located in countries of the western hemisphere. Our government forbade all business and financial transactions between citizens and residents of the United States and listed persons and firms, unless specifically permitted by licenses issued by the Treasury Department. The United States has had considerable cooperation from Latin American countries in carrying out this policy, which is aimed rather definitely at depriving the Axis powers of any economic advantages they previously derived from enterprises, investments, and business connections in the Latin American countries.

Export Control.—The freezing orders and the Proclaimed List affected both exports and imports of the United States, and our exports have also been subjected to direct control. Exports of certain goods to other countries under specified conditions were controlled or forbidden by the neutrality legislation as far back as 1935, and tin exports were controlled by licensing under the Tin Protection Act of 1936. In July, 1940, the National Defense Act provided for a general system of export control by means of licenses. An Administrator of Export Control was appointed immediately to decide what goods should be placed under license control, though the actual licenses were issued by the Division of Control of the State Department. In September, 1941, both of these functions were given to the Economic Defense Board (later known as the Board of Economic Warfare).

The export control system was originally intended to apply to essential raw materials, machine tools, certain chemicals, arms, ammunition, and war goods in general. However, the list was increased rapidly, and now scarcely anything included in our normal list of exports may be exported without a federal license. The export control system prevents other countries from buying here raw materials and goods which are needed in our own war program, but permits us to send all kinds of

goods to the countries of the western hemisphere which are collaborating with the United States in her war program. Even before our entry into the war, export control enabled us to interfere with and hamper the war activities of the Axis nations.

The "Lease-Lend" Policy.—The lease-lend policy of the United States has also had an important effect on our exports. This policy was provided for in the Act to Promote the Defense of the United States, passed in March, 1941. This Act authorized the President to sell, transfer title to, exchange, lease, lend, or otherwise dispose of various defense goods to other countries whose defense is deemed vital to the defense of the United States. Defense articles in this connection include (1) weapons and munitions of war, (2) machinery, facilities, tools, materials, parts, and supplies necessary to the production, maintenance, and repair of war weapons and goods, and (3) any agricultural, industrial, or other commodity or article for defense. All such goods may be released for export to these other countries. There are many other provisions of the Act, but these are the chief ones which affect exports directly.

By July 31, 1943, lease-lend aid to Great Britain, Russia, China, and other allied nations had amounted to \$13,973,000,000, or about three-fourths of the \$18,410,000,000 which had been provided for in three direct appropriations for lease-lend before Pearl Harbor. No *direct* appropriations for lease-lend have since been made, but the administration in charge of lease-lend has been authorized to transfer goods to our allies from the army, navy, and maritime commission, up to a maximum value of \$35,970,000,000. Of the lease-lend aid which the United States had extended by December, 1942, 77 per cent went to the British Empire, 18 per cent to Soviet Russia, and 1.8 per cent to China.²⁵ Some of our lease-lend shipments are being repaid currently by "reverse lease-lend," for commodities and services are being supplied the United States and her armed forces by Great Britain, Australia, New Zealand, and other countries.

The lease-lend policy was necessary if Great Britain and the other countries fighting the Axis powers were to obtain from the United States the goods essential to their prosecution of the war. Their financial reserves in the United States were dwindling and their exports of commodities, services, and gold were not sufficient to pay for the goods they had to import. The lease-lend policy avoids complications which arose from our method of giving aid to our allies in the first World War. Our present allies borrow no funds and have no foreign exchange problem. They obtain physical goods from this country, the orders for the goods they need are combined and coordinated with those for war goods needed by the United States government for its own use, and no problem of monetary war debts is created to cause trouble after the war. The Act specifies that lease-lend aid may be given under any

²⁵ *Chicago Tribune*, January 26, 1943, and November 12, 1943.

terms and conditions which are satisfactory to the President, and that the resulting benefit to the United States may be payment or repayment in kind or property, or any other direct or indirect benefit which the President deems satisfactory.

International Trade of the United States in Wartime.—Clearly, the various governmental controls which have been applied to the international trade of the United States since the outbreak of the second World War have not all made for a decline in trade. Some policies, such as the lease-lend program and the overall purchasing agreements for strategic and critical materials, have tended to increase trade. As a result, the total volume of international trade has increased year by year since 1939, as may be seen from the figures in Table C.

TABLE C.—INTERNATIONAL TRADE OF THE UNITED STATES, 1939-1943²⁶

<i>Year</i>	<i>Exports</i>	<i>Imports</i>	<i>Total Trade</i>
1939	\$3,177,000,000	\$2,318,000,000	\$ 5,495,000,000
1940	4,021,000,000	2,645,000,000	6,666,000,000
1941	5,146,000,000	3,345,000,000	8,491,000,000
1942	7,826,000,000	2,743,000,000	10,569,000,000
1943 (6 months)	5,487,000,000	1,552,000,000	7,039,000,000

The expanding total volume of trade in the past two years was the result of sharply increasing exports which have more than offset declining imports. Lease-lend exports of war goods, foods, and industrial materials have played a very important part in increasing total exports. In 1942, for example, total exports of \$7,826,000,000 were composed of \$4,668,000,000 of lease-lend and \$3,158,000,000 of ordinary exports.²⁷ The decline in total imports is chargeable to a shortage of shipping and to the fact that the war has cut us off from our customary supply of several very important imports.

Extensive changes have taken place in the composition of our imports and exports since the beginning of the war. In 1941 our imports of essential materials accounted for about 40 per cent of our total imports, while raw materials, foods, and partly processed goods amounted to 87 per cent, a figure which may be compared with 46 per cent in the more nearly normal year of 1939.²⁸ In 1942, strategic and critical materials comprised approximately half of our imports. On the export side, war goods and food products, which had previously been comparatively unimportant, made up 41 per cent of our total exports in the first three-quarters of 1941. In 1942, over 60 per cent of our total exports were of such goods.

²⁶ *Foreign Commerce Weekly*, May 9, 1942, p. 6; *Survey of Current Business*, February, 1943, p. 9, and September, 1943, p. S. 21.

²⁷ *Survey of Current Business*, February, 1943, p. 9.

²⁸ *Ibid.*, February, 1942, p. 48.

There have also been important changes in our volume of trade with particular countries and areas of the world. Since the third quarter of 1941, considerations of national security have prevented the publication of the details of our trade with specific countries, but happenings in the first three quarters of 1941 reveal some interesting facts. In that period, our exports to continental Europe declined 80 per cent, as compared with the same period of 1940, while our imports from this region declined 45 per cent. Exports to Japan in the first nine months of 1941 were 65 per cent less than in the same period of 1940, and imports from Japan were 27 per cent less. Trade with Japan virtually ceased when Japanese funds and property in the United States were "frozen" in July, 1941. But exports to the British Empire were 51 per cent greater in the first three-quarters of 1941 than in the same period of 1940.²⁸ The inflow of capital funds in several previous years was changed to a relatively small net outflow of \$497,000,000 in 1941, and net gold imports fell to \$982,000,000, a figure much smaller than in most recent years.²⁹

Our trade with Latin America, which had increased about 24 per cent in 1940 as compared with 1939, expanded further in 1941.³⁰ Indeed, our imports from Latin America in the first nine months of 1941 exceeded those for the entire previous year. For the whole of 1941, the Latin American countries had an export surplus of \$150,000,000 with respect to the United States, as compared with import surpluses of \$107,000,000 in 1940 and \$51,000,000 in 1939.³¹ In the two-year period 1939-1940, we had the following import increases from Latin America: copper, 95 per cent; petroleum, 152 per cent; wool, 499 per cent; and hides, 149 per cent.³² At the beginning of 1942, the United States was said to be getting 35 per cent of her copper, 20 per cent of her tungsten, 25 per cent of her zinc, 20 per cent of her lead, and 33 per cent of her antimony from Latin American countries.³³ While specific data are not available, there is no doubt that these trends have continued and the importance of Latin America in the international trade of the United States has obviously increased greatly under the influence of the second World War.

International Trade in the Future.—The international trade of the United States for the duration of the war will probably follow the lines indicated in the past two years. Exports, under lease-lend influence, will remain at a high level, and may show a considerable further increase. They will undoubtedly continue to exceed imports by a large amount annually. Imports are unlikely to rise much above their present level, even though the shortage of shipping is less than formerly. Although we have made determined efforts to maintain imports of strategic materials

²⁸ *Ibid.*, p. 50.

³⁰ *Foreign Commerce Weekly*, April 5, 1941, p. 3.

³¹ *Ibid.*, January 31, 1942, p. 8.

³² *Ibid.*, April 5, 1941, p. 4.

³³ *Ibid.*, January 10, 1942, p. 9.

and foods, the fact remains that we are cut off from our usual sources of supply of such goods as rubber, tin, and silk in the Far East. We have customarily imported 97 per cent of our rubber, almost all from the Far East, and this raw material was our leading import in 1939. Tin, 90 per cent of which we normally get from the Far East, ranked eighth among our 1939 imports, and raw silk ranked fifth. We ordinarily secure about one-fourth of our raw materials from the Far East; and even in the first nine months of 1941, 22 per cent of our total imports by value came from areas which are now under Japanese domination.

We have reacted to these conditions by increasing our imports of some materials from Latin America, by trying to develop additional sources of supply in the western hemisphere, by rationing, by developing artificial substitutes, and in some cases by simply going without goods which we are used to having. The effects of these developments on the post-war international trade of the United States cannot be foreseen with accuracy at the present time. If we continue to encourage Latin American countries to build up facilities for producing tin, copper, rubber, and other strategic materials at high cost during the war period, what will happen when and if our usual low-cost sources of supply again become available? If we develop the manufacture of synthetic rubber so fully that we can supply all our domestic needs with this American substitute, what will be done with the product of the Malayan rubber plantations after the war? If we become accustomed to getting along without silk and tea, what will become of these heretofore important import items in the post-war period? Shall we have another export boom after the war, based upon the reconstruction of large areas of Europe and Asia and upon the grant of huge international loans to other countries? Shall we be able to maintain the present degree of economic solidarity within the western hemisphere in view of the fact that the economies of North and South America are normally more nearly competitive than complementary? These and many other questions must await the end of hostilities to find answers.

WARTIME PUBLIC FINANCE

Since our war activities involve enormous expenditures by the government of the United States and equally prodigious feats in raising funds through taxation and borrowing, problems of public finance are among the most important that we face at the present time. But within this important field, it is difficult to give definite answers as yet to the many questions which present themselves.

The Cost of the War.—It is impossible to get even a remote idea of the total cost of this war to the United States. One cannot even estimate the *direct* cost of the war in terms of dollars and cents, to say nothing of the costs involved in dislocations and maladjustments within the economy,

in post-war business depressions and unemployment, in possible losses of social gains now enjoyed by workers, in possible lowered national health and vitality, and in Americans killed, maimed, and perhaps gassed. However, on the financial side of the picture, we know that the expenditures of the federal government in the fiscal year 1942 amounted to \$32,491,000,000 (including about \$26,000,000,000 for war), while in the fiscal year 1943 they reached \$78,179,000,000 (including \$72,109,000,000 for war).³⁴ In the fiscal year 1944, total federal expenditures may reach \$100,000,000,000, and expenditures for war \$90,000,000,000. Federal revenues, mostly from taxation, have been lagging far behind expenditures. They were \$12,799,000,000 in the fiscal year 1942, and \$22,282,000,000 in the fiscal year 1943.³⁴ The public debt of the federal government, which was \$49,000,000,000 in July, 1941, was \$76,991,000,000 by June 30, 1942, and \$140,796,000,000 by June 30, 1943.³⁴ In something less than one-third of the fiscal year 1943, total expenditures were \$27,049,000,000, revenues were \$11,608,000,000, and the public debt had increased to \$168,614,000,000.³⁵

Taxation in 1942.—In an effort to pay through taxation as large a part as possible of the growing federal expenditures, tax rates were increased sharply by the Revenue Act of 1942. In the personal income tax, exemptions were lowered from \$1500 to \$1200 for a married couple, and from \$750 to \$500 for a single person. The allowance for dependents was cut from \$400 to \$350 for each dependent, and a head of a family who received a \$1200 exemption solely because of dependents was not allowed to deduct an additional \$350 for the first dependent. The rate of normal tax on taxable net income was increased from 4 to 6 per cent, and the surtax was applied at the rate of 13 per cent, instead of 6 per cent, *on the first dollar of taxable income*. The surtax increased rapidly on taxable incomes above \$2000, and reached 82 per cent on surtax net incomes of \$200,000 or more. (Formerly, the maximum rate of surtax became effective only at the \$5,000,000 level.) The optional method of filing certain income tax returns (which gives automatically the amount of tax to be paid on incomes of \$3000 or less derived wholly from salaries, wages, other forms of compensation for personal services, dividends, interest, rents, annuities, or royalties) was continued from the Revenue Act of 1941. The Act of 1942 also provided a new credit against taxable income for all medical expenses in excess of 5 per cent of net income, with a maximum credit of \$2500.

A further levy on personal incomes was the so-called Victory Tax. This tax of 5 per cent on all income above \$12 a week, or \$624 a year, which went into effect on January 1, 1943, is deducted at the source (by the employer) in the case of wages and salaries. Victory Tax credits up

³⁴ *Chicago Tribune*, July 3, 1943.

³⁵ *Ibid.*, October 20, 1943.

to 25 per cent of the tax (not over \$500) in the case of single persons, up to 40 per cent (not over \$1000) for married persons, and up to 2 per cent of the tax (not over \$100) for each dependent, were provided. These credits could be taken (deducted from taxes) on March 15, 1944, when final settlement of taxes on 1943 incomes had to be made, or could be allowed to accumulate and be taken as a refund after the war. The credits were contingent upon the individual having paid equivalent amounts from 1943 income for life insurance premiums, for the retirement of debts in force on September 1, 1942, or for purchases of government bonds.

The Act maintained the normal tax of 24 per cent on the net taxable income of corporations in excess of \$25,000, but the surtax rate was raised from 6 to 10 per cent on surtax net incomes of \$25,000 or less and from 7 to 16 per cent on those over \$25,000. A flat 90 per cent tax on excess profits was substituted for the former graduated scale of 35 to 60 per cent. The two methods formerly specified for computing the excess profits tax³⁶ were retained in general, though the average earnings base was revised by the insertion of a relief provision and the invested capital base was reduced somewhat for the larger corporations. A post-war rebate of 10 per cent of the excess profits tax was provided, or alternatively credit against this tax might be taken for 40 per cent of amounts paid out for debt retirement during the taxable year so long as such credit did not exceed the amount of the available post-war rebate. The capital stock tax and "declared-value excess profits tax" were retained as before. The former tax was to be levied at the rate of \$1.25 per \$1000 of declared valuation, and the latter at 6.6 per cent on net incomes between 10 and 15 per cent on the declared valuation, and 13.2 per cent on net incomes in excess of 15 per cent on the declared valuation. It was also provided that all taxes combined must not take away more than 80 per cent of any corporation's net income.

The rates of the estate tax were not changed by the Revenue Act of 1942, but the estate tax exemption was made \$60,000 flat, instead of the previous \$40,000 general exemption plus an exemption of \$40,000 for life insurance. The rates ranged from 3 per cent on the parts of estates which barely exceed the exemption to 77 per cent on the parts of estates in excess of \$10,000,000. The gift tax rates were continued at three-fourths of the rates of the estate tax. Excise taxes were increased on cigars, cigarettes, liquor, beer, travel by train, airplane, or bus, slot machines, photographic apparatus, lubricating oil, telegraph and cable messages, and telephone service. The tax on transportation of goods by freight or express was lowered from 5 to 3 per cent of the charges paid. Social security payroll taxes were "frozen" for another year for both employers and

³⁶ Paul F. Gemmill and Ralph H. Blodgett, *Economics: Principles and Problems* New York, Harper & Brothers, rev. ed., 1942, vol. 2, p. 278.

employees, instead of doubling automatically on January 1, 1943, as had been scheduled.

"Pay-As-You-Go" Taxation.—Another tax bill relating to personal incomes became law in June, 1943. This Act did not change the rates of the income tax, but was designed to put income taxpayers on a current basis so that they would pay each year the income taxes due on that year's income rather than taxes due on the preceding year's income. The method of getting taxpayers shifted to a current basis is complicated. In the first place, a 20 per cent withholding tax on wages and salaries above basic exemptions (for single persons, married persons, and dependents) went into effect on July 1, 1943. This withholding tax was intended to cover normal tax, surtax, and the Victory Tax at 3 per cent for the first \$2000 of net taxable income for all taxpayers affected. The final rate on the Victory Tax remained 5 per cent, but only 3 per cent was to be collected in advance. The remainder was to be paid when the final income tax return was made in the following March unless, because of payments of debt or life insurance premiums or purchases of government bonds, the taxpayers had acquired credits against the Victory Tax which offset the remaining 2 per cent.

To ease the burden of shifting to a current basis of tax payments, which would otherwise have required taxpayers to pay both 1942 and 1943 income taxes during 1943, a measure of tax abatement was provided. A full year's tax (that for 1942 or 1943, whichever was smaller) was "forgiven" for income taxpayers whose annual tax was \$50 or less. Persons owing up to \$66.67 were also given a \$50 abatement. Those whose income taxes were about \$66.67 in both years were granted an abatement of 75 per cent of the taxes for 1942 or 1943, whichever was smaller.

All income taxpayers whose 1943 taxes exceeded their taxes for 1942 were required to pay their 1943 taxes during that year, in so far as this was possible. Against this tax, they were credited with the March and June income tax installments which they paid (supposedly, at the time, on the 1942 tax), the amounts withheld from them in the first six months of the year on account of the Victory Tax, and the amounts to be taken from them in the last half of the year on account of the 20 per cent withholding tax. If these credits were not sufficient to wipe out the income tax (plus the Victory Tax) for 1943, the balance of the tax total was to be paid in two installments on September 15, 1943, and December 15, 1943. Although the 1943 tax would thus be paid in full on *estimated* income for 1943, a final return on the basis of *actual* 1943 income had to be filed by March 15, 1944. If the taxes paid during 1943 exceeded the actual tax as computed after the year was over, the taxpayer received a refund from the government. In the converse case, an additional amount of tax had to be paid to the government. At the same time (March 15,

1944) these taxpayers were obligated to pay at least one-half of the 25 per cent of the 1942 taxes which was not abated by the government; and they had also to estimate their income and income tax for 1944, and to pay a quarterly installment in case the amounts withheld from them in the first quarter of the year were not large enough to cover one-fourth of their estimated income tax for 1944.

Income taxpayers whose taxes for 1942 exceeded their estimated taxes for 1943 were required to pay their 1942 taxes in full in 1943. Against these taxes they credited the installments paid in March and June, 1943, the Victory Tax withheld in the first half of the year, and the amounts withheld in the last half of the year under the 20 per cent withholding tax. If these credits were too small to wipe out the 1942 tax, the balance had to be paid in two installments, on September 15 and December 15, 1943. Then on March 15, 1944, these taxpayers were required to make a final return on their 1943 incomes (covering income tax and Victory Tax). Since they will have paid their 1942 taxes in full, they must pay only 25 per cent of their 1943 taxes, the amount due being payable in two installments—on March 15, 1944, and March 15, 1945. Like the other taxpayers, they must estimate their 1944 incomes and taxes and pay an installment on March 15, 1944, in case the amounts withheld from them in the first quarter of the year should not be enough to cover one-fourth of their estimated taxes. It was estimated that this plan would place 90 per cent of the income taxpayers on a current basis at once, and would bring the rest to a current basis within two years.

In general, we approve the shifting of income taxes to a current basis. Most people will probably be glad to have their income taxes for a given year paid approximately in full by the end of that year, and not hanging over them to be paid out of the following year's income. The new plan will presumably reduce sharply the number of defaults in income tax payments. A few years ago, when the income tax was paid by only 4 million persons who were accustomed to paying such a tax and to providing for it, it did not matter greatly that the taxes for a given year were paid during the following year. Now that we have ten times as many income taxpayers, many of whom are without experience in providing for the tax, it is quite possible that many would spend their total incomes in a given year in the absence of the new plan, and would find it difficult or impossible to pay taxes on these incomes in the following year. In all such cases, the collection of income taxes currently by withholding seems desirable. In wartime, with governmental expenditures increasing rapidly, it is desirable from the point of view of revenue to have current income tax collections based on the large incomes of the present year rather than the (presumably) smaller incomes of the preceding year. Finally, from the point of view of preventing inflation, it

is desirable, with national income increasing from year to year, to have current taxes based on large current incomes rather than the smaller incomes of the preceding year.

Taxation in 1944.—No further increases have been provided in income taxes or other taxes applicable to 1943 incomes. However, the President called on Congress to enact a new tax law in the fall of 1943 which would provide further tax increases for 1944, on the ground that revenues, even under the tax increases of 1942 and the shift to a current basis of income tax collection, would be quite inadequate in the face of rapidly increasing federal expenditures for war. Early reports held that an increase of 16 billion dollars in taxes would be requested of Congress, but when the Treasury Department finally laid its proposals before Congress, an increase of "only" 10½ billion dollars was requested. Of this sum, some 6½ billion dollars was to be derived from increases in income tax rates, lowered income tax exemptions, and other changes affecting the personal income tax. However, the Ways and Means Committee of the House of Representatives refused to make further increases in taxes on personal incomes.

We are inclined to agree with this attitude of the Ways and Means Committee with respect to the personal income tax, although we still believe that the personal income tax is, on the whole, a highly desirable type of taxation. However, personal income taxes have now reached a point where the desirability of further increases is rather questionable. It is clear that great additions to revenue cannot be raised by further increases in the rates on large incomes, for these rates are already extremely high. Moreover, large increases in rates (or lowered exemptions) for middle-class salaried and professional workers with incomes of \$3000 to \$10,000 a year may prove almost ruinous, since these persons have relatively fixed incomes (even when salaries are not frozen), have not benefited from the war prosperity to any appreciable extent, have substantial fixed expenses and obligations to meet (such as insurance premiums and payments on homes), and have already been hard hit by rising taxes and increased costs of living. Surely these people cannot be accused of having in their possession excess incomes which are a constant inflationary threat to the price structure. If further increases in personal income taxes must be made, we think that account should be taken of the fact that, while the incomes of many persons have increased greatly in wartime, those of many others have remained stable or have even declined in the face of increasing taxes and rising prices. That is, additional taxes on personal incomes should be levied entirely on those portions of individual incomes for 1944 and 1945 which are in excess of the incomes received by these same persons for (say) 1941, instead of on incomes in general. This principle is not at all revolutionary; for it has already been used in other countries in wartime.

Taxes on corporate incomes are also very high, and the Treasury Department has recommended an increase of only a little over a billion dollars in revenue from this source. With corporate net incomes in many cases already subject to normal and surtax rates which together take away 40 per cent of net income, and with excess profits subject to a flat 90 per cent tax, it seems doubtful that much more revenue can be gained from this source by increasing rates. Further increases in rates might well destroy business initiative and interfere with the vital program of production for war; and they might also be so high that our taxgathering machinery would be unable to collect them.

Nothing that might be done about the estate tax would prove very helpful in the present financial emergency, but excise taxes will undoubtedly be both extended to more commodities and services and increased in rate. Moreover, since it seems that other revenue measures under consideration will not yield as great an increase in federal revenues as is desired, there is some sentiment in Congress for passing a general federal sales tax, or turnover tax, of about 10 per cent. The chief economic objection to such a tax—that it is regressive—loses much of its force in wartime. When persons in moderate and well-to-do circumstances are paying direct taxes at highly progressive rates, and ordinary wage earners are receiving greatly increased incomes because of the war boom but paying small income taxes, if any at all, the fact that a sales tax bears relatively more heavily on persons with small incomes than on those with large incomes is less significant than in normal times.

It is also sometimes objected that a sales tax would have an inflationary result. If placed on manufacturers or other producers, the tax is ordinarily shifted to the final consumers, in whole or in large part. This shift takes place by means of rising prices. If the proposed federal sales tax were to be shifted, present ceiling prices could not possibly be maintained. On the other hand, if prices could not be raised and the tax could not be shifted but had to be absorbed by business enterprises, thousands of bankruptcies might result and production would be most seriously hampered. However, if the tax should be levied directly on purchases made at retail and be paid separately from and in addition to regular prices, it would not be necessary to revise the system of ceiling prices at all, and the tax would affect manufacturers and other enterprisers only in so far as they suffered a reduction in the volume of business, or, in the case of retailers, to the extent to which costs were involved in the collection of the tax. Then if the demands of workers for increased wages, after the tax had been imposed, could be resisted, it should have no inflationary effect of importance. The chief remaining objections to the federal sales tax are political in character. The workers, through their national organizations, have given notice of their intention to ask for wage increases if the federal sales tax is enacted, and the President, wish-

ing to remain on friendly terms with labor, has indicated that he will not approve the tax.

Public Borrowing.—Whatever may be done by way of increasing taxes, it is clear that federal tax revenues will fall far short of covering our tremendous expenditures for war, and that the great federal program of public borrowing must be continued. In so far as is possible, the government bonds should be sold to private individuals (and companies) who will purchase them out of *current* income. When bonds are purchased from current income, they help to cut down the inflationary margin between the money incomes in the hands of the people and the total value of consumers' goods and services available for civilian use, as we explained earlier. On the other hand, when the government borrows from the banks, demand deposits are almost certain to be increased, and the ultimate effect is to increase the inflationary margin. It is not that increases in demand deposits actually increase the national money income, but rather that the demand deposits created by the banks in favor of the government are eventually transferred to private individuals and firms; and when these deposits are drawn upon, the total effective demand for commodities and services is increased. To put it another way, borrowing through the banks leaves the total national money income, after taxes are deducted, in private hands and then creates a large additional sum of purchasing power for purposes of governmental expenditures. Such borrowing is inflationary, and tends to offset the desirable deflationary effects of taxation and bond purchases out of current income. Continued heavy borrowing from the banks would increase the difficulty of maintaining the price ceilings which have been established for commodities and services.

The federal government and its Treasury Department are quite aware of these facts, and they have made strenuous efforts to induce the people to buy large amounts of war bonds out of current income. In a campaign which began early in 1942, several millions of wage earners, salaried persons, and others with regular incomes pledged themselves to buy war bonds or savings stamps each week or month in an amount equal to at least 10 per cent of their regular incomes. Sales of bonds to persons who presumably pay for them out of current income increased from about 2½ billion dollars in 1941 to almost 12 billion dollars in the twelve months ending June, 1943. It is also sometimes proposed that, if voluntary sales do not prove adequate, we adopt a compulsory plan which would withhold (say) 15 per cent of all wages and salaries per month and invest these funds in war bonds and stamps. To carry out such a plan in addition to existing taxes would, of course, demand great sacrifices of many persons. The strongest objection to the plan is that it would presumably treat all receivers of wages and salaries equally, and, since personal circumstances vary greatly, the result would not be anything like equal

sacrifice as between individuals. Another objection is that a compulsory program of bond buying might almost completely wipe out the voluntary purchases which are now being made by individuals, since many people would not make voluntary purchases if they were also compelled to buy large amounts of bonds. In this event, the income position of the government would be improved and the inflationary gap reduced only to the extent to which the new compulsory purchases of bonds exceeded the old voluntary purchases.

The National Debt.—Regardless of the method by which government bonds are sold, one thing is clear—the public debt of the federal government will continue to increase by leaps and bounds. Already, as we have seen, the debt increased from 49 billion dollars in 1941 to almost 169 billion dollars as of October 19, 1943. If the war should be long, it would not be surprising if the debt eventually reached 300 billion dollars. What are the implications of a debt of this size? In the first place, we may say that the prospective enormity of the debt in no wise modifies the general principles which we have enunciated elsewhere with regard to the nature of the cost involved in public borrowing or the distribution of the “burden” involved in borrowing, as between the present and the future. It is most unlikely that the debt will increase so greatly that the credit of the federal government will be ruined, further borrowing be impossible, and the government have to resort to the printing of paper money to meet its expenses. The government’s credit is strong in time of war and, in any case, when an economy is as completely controlled by the central government as the American economy is and will be in this war, the government can go on borrowing and increasing the public debt almost indefinitely without reaching the end of its financial rope. So far, the government has floated two enormous war loans, in addition to all regular sales of bonds, and both loans have been greatly oversubscribed.

However, there is one sure implication to be drawn from the probability that we shall have a huge federal debt—this is that we must change the traditional American attitude toward this debt. In the past, when the national debt was small, the prevailing opinion was that the government must not only pay interest on the debt but must some day pay back the principal sum *in toto*. Such an attitude would be meaningless with respect to a public debt of 300 billion dollars, and we must reconcile ourselves to the fact that the principal sum of such a debt will probably never be paid. The government will not repudiate the debt, the owners of bonds will get their interest on schedule, and these owners, as individuals, will be able to recover the principal sums which they have invested. But individuals will be able to withdraw from ownership of the bonds only because others are willing to buy these government obligations from them. Anyone who would rather receive 2 or 3 per cent interest from the government than to hold cash or other investments will

be willing to buy or hold bonds, while anyone who prefers to have cash or other investments rather than receive the interest of 2 or 3 per cent will sell them—but the debt as a whole will go on and on.

There is nothing very revolutionary about this situation. England has had a public debt of this kind for many years, and is not disturbed by it. People buy and sell the Consols, as the bonds are called, according to the relative strength of their preference for holding cash or other investments, or for receiving the moderate rate of interest which the bonds pay, and no one expects the debt to be paid off. In such a situation, the "burden" of the debt consists of the annual service charge, or interest. In our case, this burden will not be light, for a debt of 300 billion dollars at an interest rate of 2 to 3 per cent would result in a total annual interest charge of 6 to 9 billion dollars, or a sum greater than the total ordinary expenditures of the federal government in each of many recent years.

CIVILIAN CONSUMPTION IN WARTIME

The problem of civilian consumption in wartime may be stated very simply. As the production of war supplies increases, the land, labor, and capital available for making civilian goods shrink with every passing day. In a conflict such as the second World War, there can be no such things as "enough" war equipment until the enemy has been decisively defeated all along the line. This means that the make-up of *total* production moves slowly but surely in the direction of a larger proportion of war supplies and a smaller proportion of goods to satisfy civilian wants. The only limit to this movement is the necessity of providing sufficient consumption goods to maintain civilian health and morale, and thus insure the efficient performance of civilian functions that are essential to war production. In a word, the armed forces have first claim upon all goods which are not absolutely necessary to the life, health, and efficiency of those who hold the production front.

Wartime Real Income.—The national income of a country consists of economic goods, and not money, though these goods are commonly expressed in terms of money. In 1941, the United States had a national income of approximately 95 billion dollars—that is, commodities and services whose value totaled this huge amount. Of this total, 74 billion dollars' worth of goods were for purposes of consumption. In 1942, we had a national income of 117 billion dollars; but the goods available for consumers were fewer than in 1941—with a value of about 69 billion—for some 48 billion dollars' worth of our 1942 production consisted of war supplies, new plant, and other non-consumption items. Our national income, as we have already said, may easily reach 150 billion, and in this total we may conceivably have as little as 50 billion dollars' worth of consumption goods. In this event, only one-third of our total production will

be available in the form of goods which minister directly to human comfort and well-being.

If this situation were universally understood, we should avoid much confusion which now prevails. We would then realize the dangers of the inflationary gap to which we referred in our discussion of prices, and welcome the introduction of measures which would prevent our having too much money. If the total national income consists of 150 billion dollars' worth of goods, of which only one-third is consumption goods, then it is highly desirable that would-be consumers have only 50 billion dollars of purchasing power. The possession of more than that amount cannot increase the quantity of goods they can buy, since that, in wartime, is determined directly or indirectly by government officials; all it can do is to raise the price level. The unpleasant truth is that a wartime economy has, in a given period, just so much goods for the use of consumers. This is the stuff they must live on—for there is no more!

Reductions in Consumption by Rationing.—The rule of "first things first" not only limits severely the nature and quantity of consumption goods produced in a war economy, but also dictates to some extent the distribution of these goods among consumers. Several years ago, President Roosevelt warned the people of the United States that they must make sacrifices for the sake of victory, and suggested that an appropriate beginning would be the elimination of spending for unnecessary goods and the purchase of war bonds instead. The imposition of steeply graduated income taxes has been relieving a good many taxpayers of those portions of their incomes that are ordinarily spent for luxuries. The price stabilization program launched by the President aims to hold down the cost of living and thus to maintain *standards* of living, particularly in the low-income groups, in so far as this is feasible in time of war. Though a capitalistic country is unlikely, even in wartime, to adopt wholeheartedly the principle "to each according to his needs," there is apparent in the United States at present a tendency to look after the vital interests of those who are economically weak.

When there is a shortage of a given kind of economic goods, it is ordinarily reflected in a rise in price. Some twenty-five years ago, the supply of granulated sugar in this country was so limited that the retail price rose to 30 cents a pound. The price of sugar in 1942 and 1943 would almost certainly have been much higher than the 6 or 7 cents that was currently charged, if the forces of supply and demand had gone uncontrolled. In the absence of control, the price might have soared to 50 cents or a dollar a pound, in which event the very wealthy would probably have consumed quite as much as usual, while the working classes could have afforded little or none at such high prices. But the government applied direct rationing to the distribution of sugar, requiring the presentation of official rationing stamps with each purchase and limiting

per capita consumption to one-half pound a week. This artificial limitation of demand (which was applied later to many commodities) held the price down to a moderate figure and brought about a fairly equitable distribution of sugar as between the rich and the poor.

But this type of rationing—an equal division of the available stock among all citizens who wish to buy—is not an appropriate measure for the distribution of certain scarce goods. For example, automobiles, tires, tubes, and gasoline may be used either for pleasure driving or for transportation in necessary civilian or war activities. Hence, an attempt has been made to see that essential needs are fully met before any of these goods are distributed for non-essential uses. Car owners in the eastern part of the United States, where gasoline rationing was introduced in May, 1942, were allowed first three, later four, and still later only one and one-half gallons a week per car for ordinary purposes, and were at various times denied the privilege of using their allotments for "pleasure driving." Physicians, nurses, clergymen, war workers, and others for whom automobile transportation has seemed to be in the public interest, have been required to file applications for extra rations of gasoline to meet individual, specific needs. New automobiles, tires, and tubes have been rationed more strictly, with no provision at all for ordinary civilian uses.

Sugar, automobiles, tires, tubes, and gasoline were the only items which came under direct rationing up to the middle of 1942. Bicycles were added to the list on July 9 of that year; and the Office of Price Administration, which has charge of consumer rationing, announced on June 29, 1942, that there might be need for rationing fifteen major groups of items within the next year. "It is likely that in the third or fourth quarter of this year the country will be faced with heavy demands on some very essential items," read the statement. "Several of these are in two of the basic cost-of-living groups, which means a general rationing program for the entire country. It would be folly to name any specific items which are likely to be rationed. To do so would cause immediate runs on existing stocks and bring about rationing earlier than ordinarily would be necessary."³⁷ Though official lists of articles to be rationed were lacking, unofficial forecasts were plentiful enough. One writer felt that purchases of fats and oils, wool, leather, soap, coffee, tea, and perhaps meats, fish, potatoes, and beans would soon be restricted by rationing.³⁸ Another, analyzing the probable future supply of and demand for wool, suggested that the 450 million pounds used by civilians in 1941 would drop to 360 million for 1942 and to 10 million for 1943, as compared with the military use of 150 million, 250 million, and 650 million pounds, respectively, in these three years.³⁹

³⁷ *New York Times*, June 30, 1942.

³⁸ *Nation's Business*, June, 1942, p. 27.

³⁹ *United States News*, February 27, 1942, pp. 24, 25.

Problems of Rationing.—Our early experiences with rationing revealed several errors in administration which have been or are being corrected. One obvious mistake was the procedure followed in the "preliminary" period of gasoline rationing. "B" ration cards (allotting gasoline for essential purposes) and "X" cards (permitting unlimited purchases) were so easy to obtain that they were used by many persons who should have limited their consumption of gasoline to the small weekly allotment which was granted holders of "A" cards. A further defect in gasoline rationing was the inability to check the sales made by the service stations. Theoretically, the dealers punched their customers' ration cards upon each delivery of gasoline, but they were not required to give proof that their sales conformed strictly to the rationing code. These weaknesses were remedied when the permanent system of gasoline rationing went into effect in July, 1942. Special allotments were granted by local rationing boards much less freely than in the preliminary period, and retail dealers were required to collect coupons from their customers and turn them over to the wholesalers when replenishing their stocks. This new arrangement increased enormously the difficulties of "chiseling," but did not eliminate illegal sales entirely.

Rationing has thus far met with a reasonable degree of cooperation on the part of the consuming public, and will probably work out more satisfactorily as time goes on. People do not willingly sacrifice unless they are convinced that sacrifices are necessary and that others are contributing their fair share of self-denial. The early administration of gasoline rationing gave rise to charges of unfairness; and the published statements of sugar producers and refiners, to the effect that warehouses were bulging with surplus sugar,⁴⁰ led many to wonder whether sugar rationing was really necessary. Conflicting newspaper stories, purporting in certain instances to be quoting public officials, caused some persons to doubt also the existence of a genuine gasoline shortage; and the rumor that gasoline was being rationed to save rubber brought the demand that gasoline rationing be made nation-wide so that all, and not merely the car owners of the Atlantic seaboard and other regions remote from the main oil fields, might economize in the use of rubber. However, there is no reason to believe that Americans are unable or unwilling to accept whatever degree of rationing may be asked of them, provided only they are persuaded that there are real shortages of the rationed goods, and that the system of allotment is equitable. We are, of course, unlikely to be called upon to make as great sacrifices as have been required of the people of other nations. "The highest living standards in the world, on the eve of the nation's entry into the war, will be our mightiest resource in enduring the strain of conflict. . . . Durable and semi-durable goods purchased in recent years will last a long time. Similarly, the stored

⁴⁰ Cf. H. A. Benning, president of Amalgamated Sugar Company of Ogden, Utah, in *New York Times*, June 20, 1942.

health and vitality of the bulk of the people will provide a backlog of energy to be drawn on in the immediate future and in years to come, if necessary.”⁴¹

Nevertheless, it is important that whatever goods we ration shall be distributed with a minimum of confusion and a maximum of utility. It may be necessary to make further changes in our methods of rationing if this goal is to be attained. It has been suggested, for example, that it might be well to have the same rationing authority and the same ration stamps for all or almost all of the necessities of life which must be rationed. “Personal needs differ, and the needs of each person have to be adjusted among themselves. Some people do not drink coffee at all. Some would prefer gas to sugar, others sugar to gas. For the individual concerned, it would be far simpler if he were allowed to make his own choices, within a limited range of purchasing power; just as he does normally. If, for instance, each of us had stamps good for the purchase of \$500 or \$600 in goods per year, and could distribute them as we pleased among the rationed commodities, much of the confusion would vanish. Whether this would result in the disappearance from the market of the goods which are most scarce is a question that would have to be carefully considered, but there might be less trouble on this score than would be feared, and no more trouble than the present system.”⁴² This method of rationing has since been adopted to a considerable extent. For example, certain “points” may be used in buying any kind of meat products (though there are great differences in the number of points required for different kinds of meat), and other points may be used for canned goods of any kind.

Another plan, proposed by Jerome Weinstein, “would not limit purchases absolutely to the minimum standard, but would tax the retail buyer progressively for purchases above this standard. That is, the essential allotment of stamps he would receive free, as at present. But if he wanted more, he would have to pay the government for them. And he would have to pay still more for a third lot. This, Mr. Weinstein points out, is a good substitute for a sales tax. It would exempt completely goods bought up to a minimum subsistence standard. The government would collect the tax directly from the consumer. The result would be (a) a discouragement of excess purchases and (b) a means of insuring that the higher prices accompanying excess demand would result not in inflationary profits but in more government revenue.”⁴² This arrangement would seem to carry the disadvantage of relieving persons with large incomes of the necessity of limiting their consumption of rationed goods, and might lead to widespread dissatisfaction. Doubtless we shall

⁴¹ National Industrial Conference Board, Inc., *America's War Effort*, May, 1942, p. 16.

⁴² *New Republic*, June 15, 1942, p. 817.

find the best way to handle commodity shortages only after further experimentation. One point that seems to be sufficiently clear is the complementary nature of commodity rationing and commodity price control, for "price control without rationing, or rationing without price control, can lead only to chaos in distribution. The rationing system attempts to substitute the criterion of need for the criterion of demand (ability to pay) as the basis of distribution. The effect of rationing, of course, is to make available to the lower-income classes a larger supply of the commodity than would be available under free prices."⁴³ If the scheme worked perfectly, it would presumably divide scarce goods among civilians in such a way as to bring about an approximate maximization of utility.

1. Why does modern warfare, in contrast with older types of military conflict, affect greatly the economic life of a nation?
2. Why are we justified in dating from September, 1939, rather than December, 1941, the effects of the second World War upon the American economy?
3. What is there about the fascist countries which is likely to give them an initial advantage over democratic nations in carrying on war, but which may in the long run prove to be a handicap?
4. Give some idea of the extent to which our *total* production in the United States has been increased by war activities. What *general* measures have we adopted for increasing our production of war supplies?
5. Explain the functions of the War Production Board.
6. What is the nature of, and the necessity for, the Production Requirements Plan?
7. Discuss congressional appropriations for war purposes, indicating some of the specific purposes for which the money is being spent.
8. "The process of making war supplies is, in some instances, very roundabout." Explain, with illustrations.
9. Describe the sort of problems that war brings to small producers and to producers of "non-essential" goods.
10. Discuss the shifts of workers, as between industries, which have resulted from war production and the movement of workers into military service.
11. Why do war conditions bring large numbers of industrial strikes?
12. Argue that industrial strikes should, or should not, be outlawed in wartime.
13. What is the function of the National War Labor Board? Why is it likely to be more successful than the Defense Mediation Board?
14. Why do prices and the cost of living tend to rise in wartime?
15. What are the chief provisions of the War Labor Disputes Act?
16. Why should we be especially concerned about increases in general prices in time of war?
17. How did the federal government attempt to control prices before our entry into the war?
18. Explain the aims and methods of the General Maximum Price Regulation.

⁴³ A. C. Neal, Editor, *Introduction to War Economics*, Chicago, Richard D. Irwin, Inc., 1942, p. 194.

19. Why were some commodities and services exempted by the G.M.P.R.?
20. How were maximum prices determined under the G.M.P.R.?
21. What has been the policy of the O.P.A. in regard to rents?
22. "The G.M.P.R. anticipated and provided for some of the problems of general price control." Explain.
23. Describe some difficulties encountered in the administration and enforcement of the G.M.P.R.
24. Discuss the degree of success achieved by the O.P.A. in controlling prices.
25. Describe the "inflationary gap" of 1943, and the potential danger of this situation.
26. Explain the relationship of subsidies to price stabilization.
27. Discuss ways of evading price ceilings.
28. "The ordinary consumer may find his cost of living going up even though prices and the cost-of-living index are entirely stable." Explain.
29. What is your opinion as to the desirability of general price control? Explain.
30. Describe the "stock-pile" program of the federal government.
31. What was the purpose of the government in entering into exclusive purchasing agreements?
32. What were the nature and purpose of the "freezing" of foreign assets?
33. How did the federal government achieve general control over exports?
34. Why did we adopt the "lease-lend" policy, and in what respects is it superior to our method of helping our allies in the first World War?
35. To what extent have we made lease-lend shipments to our allies?
36. How did war conditions affect the volume of our international trade in 1939-43?
37. What has been the effect of the current war on our trade with Latin America?
38. "Many questions remain to be answered in connection with our international trade of the future." What is the nature of these questions?
39. What was the money cost of the war to the United States in 1942 and 1943, and what is the estimated cost for 1944?
40. What is our general policy of war financing?
41. Discuss changes in federal taxation in 1942.
42. Describe the purpose and method of "pay-as-you-go" taxation.
43. What do you consider the best (that is, *socially* most desirable) types of taxation upon which to depend for obtaining additional federal revenue in 1944 and later years? Why are they "best"?
44. What difference does it make whether government bonds are purchased by individuals out of current income or are bought by banks? Explain.
45. What will be the probable effect of the war on the national debt of the United States, and on the attitude of our citizens toward this debt?
46. What is the relationship between the problem of taxation and that of maintaining price ceilings? Explain.
47. Why should we be especially concerned about increases in general prices in time of war?
48. Is effective price control possible without wage control? Explain.
49. "The complementary nature of commodity rationing and commodity price control" is stressed in this chapter. Explain why the two are *complementary*.
50. It has been estimated that approximately 50 per cent of our national income consisted of war goods in 1943. Discuss the possibility of a rise in this percentage in later years. How high do you think this percentage *could* go, and why?

51. "Commodity rationing in the United States is unlikely to demand as much sacrifice as in other countries." Why is this true?
52. What may be said *for* and *against* the rationing plan proposed by Jerome Weinstein?

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